96-115

MINOR TAX BILLS

HEARINGS

BEFORE THE

SUBCOMMITTEE ON
SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

NINETY-SIXTH CONGRESS

SECOND SESSION

ON

JUNE 19, 1980

H.R. 4175 H.R. 5512
H.R. 4511 H.R. 5847
H.R. 4544 H.R. 7229
H.R. 4646 H.R. 7538

AND

JUNE 26, 1980

H.R. 4698 H.R. 7210
H.R. 5739 H.R. 7382
H.R. 6085 H.R. 7487
H.R. 7253 H.R. 7520
H.R. 7278 H.R. 7606

Serial 96–115

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H.R. 4498
H.R. 5719
H.R. 6985
H.R. 7263
H.R. 7276
H.R. 7318
H.R. 7392
H.R. 7487
H.R. 7520
H.R. 7606

Serial 96–115

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MINOR TAX BILLS

THURSDAY, JUNE 19, 1980

House of Representatives,
Committee on Ways and Means,
Subcommittee on Select Revenue Measures,
Washington, D.C.

The subcommittee met at 9:05 a.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the subcommittee) presiding.

[Press release announcing the hearing follows:]

[Press release of June 12, 1980]

Hon. Dan Rostenkowski (D., Ill.), Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, Announces a Public Hearing on Minor Tax Bills, to be Held on June 19, 1980

The Honorable Dan Rostenkowski, (D., Ill.), Chairman, Subcommittee on Select Revenue Measures of the Committee on Ways and Means, today announced that the Subcommittee will conduct a public hearing on miscellaneous tax bills on Thursday, June 19, 1980. The hearing will be held in 1100 Longworth House Office Building, the Committee's main hearing room, beginning at 9:00 a.m.

A listing of the legislation on which testimony will be taken at this time appears on the reverse side of this announcement.

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD

The limited time available to the Subcommittee for this hearing requires that all persons and organizations having a common position designate one spokesman to represent them. Each witness must summarize his or her statement with the understanding that the detailed statement will be included in its entirety in the printed record of the hearing. The time allowed witnesses for the presentation of oral testimony will be strictly limited. If necessary, public witnesses will be grouped into panels to expedite the hearing process. Any individual or organization desiring to do so may file a written statement for inclusion in the printed record of the hearing instead of appearing in person, in accordance with the directions outlined below.

The cut-off date for requests to testify is noon, Tuesday, June 17, 1980. Requests to be heard, therefore, should be submitted by telephone to John M. Martin, Jr., Chief Counsel, Committee on Ways and Means, 1102 Longworth House Office Bldg., Washington, D.C. 20515, (202) 225-3625.

Requests to be Heard Must Contain the Following Information:

(1) The name, address, telephone number and capacity in which the witness will appear;

(2) A listing of clients (or the firm or association represented) at whose request or in whose employ the witness is appearing;

(3) Which bill or bills will be discussed; whether in support or opposition, and

(4) A summary of testimony to be presented.

Notification to those scheduled to appear will be made by telephone promptly after the filing deadline. If a witness cannot appear on the day scheduled, he may wish either to substitute another spokesman in his place or to file a written statement for the record of the hearing instead of appearing in person. In any event, if a change in the scheduled witness or cancellation is necessary, please advise the Committee office immediately.

Witnesses should submit 80 copies of their prepared statements to the Committee office, 1102 Longworth House Office Bldg., at least 24 hours in advance of the hearing. An additional supply may be furnished on the date of appearance for distribution to the press and public.

Written Statement in Lieu of Personal Appearance

Instead of appearing in person, written testimony may be submitted for the consideration of the Subcommittee and inclusion in the printed record of the hearing. For this purpose, five copies of the statement should be submitted by the close of business on Thursday, July 3, 1980. If those filing for the record want copies of their statements distributed at the hearing to the members of the Subcommittee, press and public, additional copies for this purpose should be delivered to 1102 Longworth House Office Building before the hearing begins.

BILLS TO BE ADDRESSED AT PUBLIC HEARING, JUNE 19, 1980 BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES

H.R. 4175 (Mr. Duncan of Tennessee, Mr. Conable, Mr. Bevill, Mr. Lott, Mr. Brinkley, and Mr. Frost). To amend the Internal Revenue Code of 1954 to allow a deduction for contributions for the construction or maintenance of buildings housing fraternal organizations.

Identical with: H.R. 5902 (Mr. Satterfield) H.R. 5964 (Mr. Quillen).

H.R. 4511 (Mr. Mineta, Mr. Dougherty, Mr. Ertel, Mr. LaFalce, Mr. Lagomarsino, Mr. Gilman, Mr. Martin, Mr. Matsui, Mr. Patterson, Mr. Thompson, Mr. Heftel, Mr. Goldwater, Mrs. Spellman and Mr. Fisher). To amend the Internal Revenue Code of 1954 to provide that the taxable income of a homeowners association shall be subject to the same graduated rates of tax as a corporation.

Similar to: H.R. 6855 (Mr. Bafalis). To amend the Internal Revenue Code of 1954 to tax certain homeowners associations as corporations.

H.R. 4544 (Mr. Beard of Tennessee). To amend the Internal Revenue Code of 1954 relating to estate taxes to provide that the election to use the alternate valuation date may be made on a return tha is filed late.

H.R. 4640 (Mr. Pickle and Mr. Archer). To amend the Internal Revenue Code of 1954 to exempt holdings in independent local newspapers from taxes on excess business holdings of private foundations.

H.R. 5512 (Mr. Pickle and Mr. Archer). To amend section 4941(d)(2) of the Internal Revenue Code of 1954 with respect to private foundations.

H.R 5847 (Mr. Gibbons, Mr. Young of Florida, Mr. Bafalis and Mr. Ireland). Relating to the application of section 103(b) of the Internal Revenue Code of 1954 to certain bonds for harbor improvements.

H.R. 7220 (Mr. Brown of Ohio). To amend the Internal Revenue Code of 1954 to extend for two years the period during which governing instruments may be amended to meet the requirements for a gift of a split interest to charity.

H.R. 7553 (Mr. Rostenkowski). To amend the Internal Revenue Code of 1954 to exempt from tax interest received on portfolio debt investments in the United States of nonresident aliens and foreign corporations.

Mr. Rostenkowski. The subcommittee will come to order.

Today the subcommittee is considering eight measures which make various changes in the tax law. All these bills have received, or are scheduled to receive, consideration by the Senate Finance Committee during this Congress. The subcommittee has chosen to give these particular measures a hearing at this time since in addition to whatever action the House may take, they may in the future become the subject of Senate amendments to House-passed revenue bills.

Affording these bills a hearing now insures that the committee can maintain its policy of action on only those bills which have been the subject of House hearings.

One bill on which we will be taking testimony this morning has aroused great interest. I would like to mention that I have introduced H.R. 7553, which would repeal the withholding tax on interest paid to foreign investors on portfolio indebtedness, at the request of the Department of the Treasury in order to afford it a hearing at this time.

The bill, as introduced, is identical to a provision in a bill that was reported by the Senate Finance Committee last year.

While some of these bills are noncontroversial, others may raise significant issues and areas of controversy. It is my intention to proceed expeditiously with subcommittee consideration of those bills to which there are no objection; on more controversial measures, I hope the differences can be reconciled among the interested groups prior to further subcommittee consideration.

We will hear first from Members of Congress, followed by the representatives of the Department of the Treasury and public witnesses. Mr. Duncan?

Mr. DUNCAN. Mr. Chairman, you are to be complimented for holding this timely hearing on these important bills.

In particular H.R. 4175 and H.R. 4544 make some very needed changes in our tax laws.

H.R. 4175 makes a limited technical change by allowing a charitable income, estate and gift tax deduction for contributions to domestic fraternal societies, orders or associations, operating under the lodge system, that are used for the construction or maintenance of buildings housing fraternal organizations. The bill would encourage contributions for this worthwhile purpose and deserves strong subcommittee support.

H.R. 4544 also makes a limited technical change. It amends the current requirement that, for estate tax purposes, the alternative valuation date must be elected on an estate tax return that is timely filed.

Under H.R. 4544, the alternative valuation date may be elected on the first Federal estate tax return filed. The bill thus gives executors some flexibility.

I would hope that the subcommittee will support this bill too. Thank you, Mr. Chairman.

Mr. ROSTENKOWSKI. It is certainly my pleasure to have in the room this morning two most outstanding members, both colleagues on the Committee on Ways and Means. I very much value my relationship with these colleagues. Although on occasion we vote against each other; on other occasions, we vote with each other.

Mr. Archer, if you would like to begin the testimony this morning on a measure that you are interested in, the subcommittee is ready to receive it.

STATEMENT OF HON. BILL ARCHER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

Mr. ARCHER. Thank you, Mr. Chairman. I might quickly say that we do not vote against each other, we just vote in different directions. [Laughter.]

I am certain that the chairman and the members of the subcommittee will find that H.R. 5512 is one of those noncontroversial bills and subject to expeditious treatment by the committee. I thank you and the members of the subcommittee for giving me this opportunity to testify today in support of H.R. 5512, which I have introduced with Congressman Pickle—that may ring a familiar bell with the chairman—for a necessary change in the Internal Revenue Code relating to private foundations.

Section 4941(d)(1)(A) of the Internal Revenue Code of 1954 as amended prohibits private foundations from leasing from "disqualified persons"—that is essentially lessors who have an interest in the foundation. The intent of the provision, enacted as a part of the Tax Reform Act of 1969, was to prevent self-dealing. However, this blanket prohibition also prevents leases which are entered into not for the purpose of manipulating the law for a tax advantage, but for convenience or because of a lack of office space other than at the "disqualified person's" location. A prime example of the problems caused by such a blanket prohibition is that of the Moody Foundation of Galveston, Tex.

Mr. Chairman, I might say that Galveston is neither in my district nor in Congressman Pickle's district, but we are concerned about the inequities that are being invoked as a result of the current law on the Moody Foundation.

The Moody Foundation makes annual grants to nonprofit organizations for projects in humanities, performing arts, education, health, science, community and social services. They are a major factor in health facilities and hospitals in Galveston, Tex., and do a tremendous amount of very, very beneficial philanthropic work.

Because of section 4941, the foundation is prohibited from leasing office space from the Moody Bank. The problem in this case arises from the fact that there is no other similar office space readily available in the Galveston area. I believe that the blanket prohibition should be amended to allow "arm's length" leases as defined under H.R. 5512. This exception would still prohibit "self-dealing," yet also insure that private foundations will not be unduly burdened.

Mr. Chairman, in Galveston, which is a relatively small community, there is a lack of adequate office space and the inability of the Moody Foundation to lease from the Moody Bank severely penalizes them in their operations without any benefit to the public or to the tax code.

Support for this amendment can be found in the Filer Commission's Report on Private Philanthropy and Public Needs which was done in 1975. The Commission's efforts were endorsed and encouraged by the former chairman of the House Ways and Means Committee, Hon. Wilbur Mills, and Secretaries of the Treasury, George Schultz and William Simon. In the Commission's "Research Papers" published in 1977, it was recommended that "arm's length" business relationships be permitted between tax-exempt organizations and persons linked to them. In further discussion, the Commission stated that a blanket prohibition against "self-dealing" was impractical for all voluntary organizations, placing them at a considerable disadvantage. Separate commentary by the Commission's staff went further and recommended an amendment to section 4941 similar to the one that I am introducing in H.R. 5512. I concur with the Commission's belief that the Internal Revenue Service's intensified audit program is sufficient to scrutinize the narrowly defined "arm's-length" transaction outlined in H.R. 5512.

Congress on the whole has also shown its belief that the IRS has the ability to enforce such narrowly defined prohibitions. Section 4941 was enacted in 1969, when the blanket prohibition was adopted due to the belief that the "arm's-length" exceptions were administratively difficult to enforce. But section 4975(d)(2) of the Code was enacted after section 4941 as a part of the Employment Retirement Income

Security Act of 1974—and it represents a change in congressional philosophy in providing an exception similar to the one we have proposed in H.R. 5512.

In summary, I concur with the Filer Commission's findings that the position taken in section 4941 regarding leasing between a foundation and a "disqualified person" is too harsh. Therefore, I see the Congress' implementation of a similar "arm's length" exception adopted in 1974 as evidence of its belief that such a narrowly defined exception is administratively feasible. I urge the subcommittee to favorably report this legislation at its earliest convenience. Again, I appreciate this opportunity to appear before you.

I will be happy to try to answer any questions that you might have, Mr. Chairman.

Mr. Rostenkowski. Thank you. As usual, Mr. Archer, you have explained your case in detail and I am sure that the committee will look upon this in the very near future. We appreciate your interest.

Mr. Archer. Thank you very much, Mr. Chairman.

Mr. Rostenkowski. It is now my privilege to welcome another committee colleague.

STATEMENT OF HON. L. A. (SKIP) BAFALIS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF FLORIDA

Mr. Bafalis. Mr. Chairman, it is always a delight to be before your subcommittee, and we welcome you to Florida whenever you have the opportunity to come down there.

I appreciate this opportunity to testify before your subcommittee on behalf of H.R. 6855. As you know, this is legislation which would change the tax treatment of reserve accounts maintained by condominium associations. These funds are used to pay for capital expenditures and deferred maintenance on buildings and grounds of condominiums.

Many States do not require that those funds be maintained; however, Florida statutes do require that condominium associations maintain those accounts. Once the account has been established, it then becomes subject to Federal tax laws. Quite frankly, Mr. Chairman, I think the present tax treatment of these funds is quite extreme.

Prior to 1976, such accounts were tax exempt. However, in the Tax Act of 1976, this status was repealed and earnings of the homeowners associations were made subject to the maximum corporate tax rate—46 percent.

I think to subject the earnings of all homeowners associations, whether the earnings are $2 or $200,000, to the maximum tax rate of 46 percent is just simply not equitable.

My bill, H.R. 6855, would resolve this problem by treating homeowners associations as corporations for tax purposes. Under this proposal the earnings of the accounts would be subject to the graduated scale of tax rates based on the earnings of the fund—the minimum tax rate would be 17 percent, and the maximum tax rate would be 46 percent.

I think this is fair middle ground on this issue, Mr. Chairman, and equitable to all concerned. I would urge that your subcommittee give this expeditious approval.

I might add, Mr. Chairman, there are many of these associations which invest these reserve accounts in savings and loan associations and in other investment instruments. They do not earn a great deal of money and to subject them to a 46-percent tax rate on those earnings just does not appear to be equitable.

Mr. **Rostenkowski.** You are talking about a rate just on the interest, are you not?

Mr. **Bafalis.** Yes, any earnings that they have in these accounts. We changed the law in 1976 and they became subjected to the maximum corporate tax rate which now is 46 percent. We talk about capital formation, and it seems contrary to what we are trying to accomplish when we tell these small associations that have minimal earnings that they must pay 46 percent of their earnings to the Federal Government.

So, what we are suggesting is that they pay the same tax rates that corporations do, based on their income—a minimum of 17, maximum of 46 if, by some stretch of the imagination, those earnings could ever be that large.

Mr. **Rostenkowski.** Thank you very much, Mr. Bafalis.

Mr. Duncan?

Mr. **Duncan.** I have no questions other than to thank Mr. Bafalis for his usual excellent testimony.

Mr. **Bafalis.** Thank you very much, the gentleman from Tennessee. Thank you, Mr. Chairman.

Mr. **Rostenkowski.** Congressman Vanik? Congressman Brooks? Congressman Brown? Mr. Lubick?

Welcome to the subcommittee, Mr. Lubick. It is always a pleasure to have you with us. Please proceed with your observations on the various bills that have been scheduled today.

STATEMENT OF HON. DONALD C. LUBICK, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY

Mr. **Lubick.** Thank you, Mr. Chairman. If you please, I will submit my long and involved prepared statement of 22 pages for the record and speak for a few brief moments.

Mr. **Rostenkowski.** Your entire statement, Mr. Lubick, will be included in the record.

Mr. **Lubick.** Thank you.

I would like to talk in a little detail about a few of the more important measures; then briefly state our position with respect to some of the others; and then address any questions that you may have.

First of all, I would like to talk about the subject of withholding on interest paid to foreign persons. We have on page 8 of our prepared statement a proposal of the administration for exemption from taxation of interest at the source for certain types of issues of bonds in the Eurodollar market, primarily to be purchased by foreign persons. Our position is simply that this proposal will greatly simplify current law and achieve a result that in large part is already reachable today under complicated arrangements through various of our treaty partners. We believe that enactment of this proposal would make it easier for U.S. businesses, and the U.S. Government in some circumstances, to raise capital in foreign markets.

Essentially the taxation of the U.S. income of foreign persons distinguishes between the taxation of business income and passive investment income. Business income is taxed in the same manner as in the case of the U.S. domestic taxpayer; we tax on a net basis. We take the gross income and subtract deductions and apply our statutory rates to the net income.

In the case of passive investment income, we instead apply our taxation on a gross basis. There is a flat 30-percent rate applied to this type of income on a gross basis, unless it is modified by treaty which it is in very many situations.

The 30-percent tax is withheld in the case, for example, of interest paid to a nonresident alien. That is why this tax is called a withholding tax. However no further obligation to file a return is imposed upon the nonresident alien so that in this case, the 30-percent tax is not merely a withholding tax, that is, a method of collection but, rather, it is the substantive tax. Therefore, withholding is somewhat of a misnomer.

There are a number of major exceptions to the tax on interest, both statutory and by treaty, and they are outlined in my prepared statement. I won't go over them with you. You are familiar with them because you have dealt with them over a period of years. The result, it is fair to say, is that almost all interest derived by nonresident aliens, or at least portfolio interest, is not subject to U.S. taxation. A complete exemption from taxation of interest on indebtedness derived by nonresident aliens would result in a loss of only about $33 million for fiscal year 1979.

In effect, the only category of obligation that results in taxable interest to nonresident aliens are longer term securities of nonbank borrowers such as business corporations and the U.S. Government.

As you know, a Eurodollar market has developed. We have found that capital flows freely through this market, based upon rates of return; we have also found that the taxation is a barrier to the operation of this market. In essence, we are suggesting that the taxation of interest be relegated to the country of residence of the taxpayer. In this way, taxpayers of particular countries will respond to the rate of return and their incidence of taxation will be governed by their home country. If, in a particular country, pension earnings are exempt, the U.S. Government will not impose a barrier to investing these pension funds in the United States by putting a U.S. tax on the interest income earned by these funds.

Now, you are aware that there has been a large amount of this type of borrowing through finance subsidiaries organized in treaty partner jurisdictions. This seems to be a rather circuitous route to arrive at the desirable result, promoting free access to the Eurodollar market. We are proposing a straightforward way to handle it.

At the same time, we do not want to open up tax evasion opportunities for Americans that are not presently available. Since the Senate Finance Committee reported out its bill, we have worked out a couple of modifications to it which we will suggest. We suggest that the exemption apply only in two carefully defined sets of circumstances. The first is for targeted Eurobond obligations, issued after the effective date, which are designed for distribution to foreign persons. There is an existing practice devised by the SEC to assure that obligations are intended for distribution to foreign persons. These obligations are generally in bearer form. We would suggest that with respect to those obligations meeting the SEC marketing requirements designed to assure that the obligations are intended for sale to foreign persons, there should be no withholding on interest payments.

At the same time, nonresident aliens may wish to invest in the domestic market, and, in that case, we do not think it appropriate to encourage the proliferation of bearer bonds in the U.S. market because of our own compliance difficulties. Therefore, we would suggest that for obligations in registered form, there be an exemption from interest withholding if the payee certified to the borrower that the payee is a foreign person and the beneficial owner, or if the payee is a nominee, that the beneficial owner is a foreign person.

We would take nominee certifications only from financial institutions in the business of holding securities as a nominee, who are reliable certifiers.

In essence, we think that this proposal will be very helpful in enabling U.S. corporations and the U.S. Government to tap the Eurodollar market.

Let me talk a little bit about a couple of the other bills. H.R. 5847 provides for tax exempt financing for the acquisition of certain harbor improvements, and our statement, on page 9, indicates that the proposal has been made to allow the acquisition by the Tampa Port Authority of existing harbor facilities owned by Agrico Chemical Co., which would then be leased back to a joint venture of which Agrico would be at least a 50-percent participant.

Under present law, tax exempt financing of the acquisition of an existing facility is not allowed where there is no change in the substantial user of the facility and the user receives a significant portion of the proceeds. The reason for this is clearly that we want to prevent the use of tax exempt financing simply to allow a particular beneficiary of tax exempt financing to borrow against his equity in the project and thereby refinance to obtain working capital.

Now, we are reexamining the regulations with a view to liberalizing them to permit substantial rehabilitation where the effect is to provide a new facility. But if the facilities are already in use—and in the situation described in this bill we fear that the bulk of the proceeds are designed for the acquisition of an existing structure—that would be a case where tax exempt financing would not be appropriate.

The continuing use of tax exempt financing for private purposes that we have seen over the last 1½ years in particular, has become a potential disaster with respect to our ability to exercise fiscal restraint. We have testified time and again before this committee and before the Senate Finance Committee that the use of tax exempt financing is an inefficient way to subsidize particular desirable activities. If we are going to have a subsidy, even a tax credit would be much more efficient than off-budget tax exempt financing. In effect, as much as 50 percent or more of the benefits of tax exempt financing go to high-income taxpayers, go to investment bankers and go anywhere other than the activity desired to be subsidized.

At a time when it is necessary to exercise fiscal restraint we must stop the constant erosion of the tax base by constantly moving the line of tax exempt financing for private purposes. Therefore, we regard it as very important that we not cross the line here in a situation where no new facilities are being provided. We do intend, as I stated, to work out through regulations some new rules that will make clearer the distinction between creating new facilities through rehabilitation and simply refinancing existing facilities. But we do not think that legislation is appropriate in this area.

Now, there are a number of other bills on which I will comment only briefly. The bill to provide a contribution deduction to fraternal organizations, we believe, is inappropriate since the purpose of the contribution is for the construction of facilities for the fraternal organization; that is not an appropriate source of a charitable deduction. We have already gone beyond the normal rules of charitable contribution deductions by allowing contributions for charitable purposes to fraternal organizations, even though the organization is not exclusively engaged in charity.

On the homeowners association bill, as to which Mr. Bafalis testified, we have suggested a method of handling this that seems to be appropriate. The best way to treat this would be to treat the homeowners association as a conduit, as a subchapter S corporation. That is difficult, and therefore in order to avoid the use of homeowners associations as vehicles for accumulation of income without taxation or taxation at low rates, rather than applying graduated rates all the way, we suggest taking something less than the average rate of the homeowners involved. We suggest that the 30-percent rate be applied up to $75,000 and that the regular graduated corporate rates take over from there.

In the matter of H.R. 4640 it is proposed that there be an exception from excess business holding rules for independent local newspaper businesses. Again, we think that is inappropriate. There is no particular reason why a private foundation owning a business should have an unfair competitive advantage because of its tax exemption. The rationale for the original legislation exists, whether it is a newspaper or not a newspaper. So, we see no particular reason to modify that.

Mr. Chairman, I will be very pleased to answer any questions you may have as to any of the other bills, or any of those that I commented on.

[The prepared statement follows:]

STATEMENT OF HON. DONALD C. LUBICK, ASSISTANT SECRETARY OF THE TREASURY (TAX POLICY)

Mr. Chairman and members of the subcommittee, I am pleased to have the opportunity to present the views of the Treasury Department on the following eight bills: H.R. 7553, exempting certain interest paid to non-U.S. persons from withholding taxes; H.R. 5847, allowing the proceeds of tax exempt bonds to be used to finance the acquisition and improvement of an existing wharf facility; H.R. 4175, allowing deductions for certain contributions to fraternal organizations; H.R. 4511, relating to the tax rate applicable to homeowners' associations; H.R. 4544, allowing an estate tax alternate valuation date election to be made on a late filed return; H.R. 4640, excepting certain newspaper businesses from the private foundation excess business holdings rules; H.R. 5512, excepting certain leases from the private foundation self-dealing rules; and H.R. 7220, extending the period during which governing instruments may be amended to meet the requirements for a charitable contribution deduction for a gift of a split interest to charity.

After setting out a summary and the position of the Treasury Department with respect to each bill, I will discuss each proposal in detail.

SUMMARY

H.R. 7553 would exempt from tax interest paid by United States borrowers on certain debt obligations held by foreigners. The Treasury Department supports the concept embodied in H.R. 7553 but believes the bill should be modified as described later in this statement.

H.R. 5847 would permit tax exempt financing for the acquisition and rehabilitation of certain harbor improvements. The Treasury Department is opposed to H.R. 5847.

H.R. 4175 would allow an income, estate and gift tax deduction for a contribution to a tax exempt domestic fraternal organization for the construction or maintenance of a building to house the organization. The Treasury Department opposes H.R. 4175.

H.R. 4511 makes homeowners' associations subject to the same graduated income tax rates as are applicable to corporations. The Treasury Department opposes H.R. 4511 but proposes an alternative described below.

H.R. 4544 allows an estate to elect an alternative valuation date on the first late estate tax return filed and provides a retroactive effective date and a transitional relief provision. The Treasury Department does not oppose the substantive provision of H.R. 4544 but opposes the retroactive effective date and transitional relief provision.

H.R. 4640 exempts independent local newspaper businesses from the excess business holdings provisions generally applicable to private foundations. The Treasury Department opposes H.R. 4640.

H.R. 5512 excepts the continuation of certain pre-1969 leases of office space by a private foundation from a disqualified person from the private foundation self-dealing rules. The Treasury Department does not oppose H.R. 5512.

H.R. 7220 extends for two years the period during which governing instruments may be amended to meet the requirements for a charitable contribution deduction for a gift of a split interest to charity. The Treasury Department does not oppose H.R. 7220.

H.R. 7553: EXEMPTION FROM U.S. TAX OF CERTAIN INTEREST PAID TO FOREIGN PERSONS

The Treasury supports legislation which would exempt from U.S. tax interest paid by U.S. borrowers on certain debt obligations which are held by foreigners. We believe that such legislation in the first instance would simplify current law and cleanly achieve the result that is reached in large measure by the existing pattern of taxation. Moreover, in the longer run it would contribute to the ability of U.S. businesses to raise capital in foreign markets. This, in turn, will aid the process of capital formation in the United States.

I am submitting as an attachment to my statement today a brief outline of a specific Administration proposal for eliminating the interest tax. This proposal is somewhat more limited than the exemption provided under H.R. 7553 and H.R. 2297, a measure reported favorably by the Senate Finance Committee in December. The added limitations are designed principally to ensure that the exemption provided to foreign persons does not create opportunities for abuse by U.S. taxpayers.

I would like to begin by describing the basic policy considerations supporting the adoption of a tax exemption for interest paid to foreigners.

In taxing the United States income of foreign persons, the Internal Revenue Code distinguishes between business and investment income. Business income is generally taxed to foreign persons on a "net basis"—that is, deductions allocable to the income are allowed to offset the income—and at the same rates that apply to United States persons. This is true both for foreign individuals and for foreign corporations. Certain forms of passive investment income—including interest, dividends, annuities, royalties, and other "fixed or determinable, annual or periodical" income—are taxed, by contrast, on a "gross basis"—that is, no deductions are allowed, and the tax is imposed at a flat rate. The statutory rate is 30 percent. This "gross basis" tax is enforced by withholding at source—that is, a payor of income subject to the tax simply withholds 30 percent of the payment, and pays the amount withheld to the Government. This satisfies the liability, and the taxpayer need make no return or take any further action to satisfy his liability. Hence these taxes are commonly called "withholding taxes."

Although on its face the Internal Revenue Code appears to impose a 30 percent tax on interest paid to foreign persons, in actuality the effect of various exceptions to this rule is virtually to eliminate the tax. There are several major exceptions.

First, since 1921, interest earned by foreign persons on bank deposits has been exempt from tax.

Second, as a matter of long-standing administrative interpretation, which was made a matter of statutory law in 1969, original issue discount on securities having a maturity of six months or less is not subject to the 30 percent tax. Because of this exemption there exists, and has existed for many years, a substantial international market for short-term U.S. Treasury bills, and for short-term bankers' acceptances and other short-term commercial paper.

Third, section 892 of the Code exempts interest and other investment income of foreign governments and international organizations from U.S. taxation, while section 501 (c) (3) exempts foreign charitable organizations.

Finally, under bilateral income tax conventions dating back as far as 35 years, the United States, on a reciprocal basis, either reduces the rate of tax on interest to 5, 10, or 15 percent, or provides for exemption from the tax at source. The U.S. Model Income Tax Treaty—which embodies our opening negotiating position in income tax treaty negotiations—calls for reciprocal elimination of any interest withholding tax. Many of our treaties with our major trading partners—including those with Germany, the United Kingdom, and the Netherlands contain such an exemption. Several of our other treaties contain substantial reductions of the 30 percent statutory tax on interest—for instance, our treaty with Switzerland limits our taxation to a 5 percent rate, and those with Japan and France to 10 percent.

As a result of the existing exemptions and rate reductions, we collect only a nominal amount from the tax at source on interest—$33 million in fiscal 1979, the latest year for which figures are available.

The only category of debt investments in the United States to which the statutory interest tax still applies are longer-term securities of nonbank borrowers, such as business corporations and the United States Government. For this class of debt investments, the existence of the tax poses a barrier to direct access to a well established and organized source of medium- and long-term foreign capital—the so-called "Eurodollar bond" or "Eurobond" market. This market emerged in the early 1960's, during the period of the interest equalization tax in the United States, and has developed into an important source of funds for international corporate borrowers, for government borrowing and for borrowing by international organizations. Bonds on this market are virtually unmarketable, if they are subject to interest tax at source.

Since the emergence of the Eurobond market, United States companies have struggled to find a way to tap its funds. In the early years of the market, many companies organized "finance subsidiaries" in countries with which the United States has a tax treaty. The debt of these subsidiaries, guaranteed by the United States parent, is marketed tax-free in Europe. In 1971, to obviate the necessity to resort to international finance subsidiaries, Congress adopted an amendment to the Interest Equalization Tax (IET) that permitted companies to designate certain securities issues which would be subject to the IET. Congress made any securities so designated exempt from interest tax at source. But since this provision was tied to the IET, it lapsed when the IET lapsed, on June 30, 1974. Since that time, the only means by which companies have been able to borrow in the Eurobond market is through finance subsidiaries organized in a treaty partner jurisdiction. This, for many borrowers, is an unsatisfactory method for gaining access to Euromarket funds. Furthermore, the situation requires that the United States tolerate the use of treaty exemptions by persons who are not legitimate residents of a treaty partner, a practice that is at odds with policies the United States normally pursues in negotiating and administering tax conventions.

I would like to comment on, and to compare, two measures for ending the 30 percent tax on interest—H.R. 7553 (which is identical to the measure reported by the Senate Finance Committee last December, H.R. 2297), and the Administration proposal, summarized in the attachment to my statement.

Either of these measures would ensure direct access by U.S. companies to Euromarket funds. H.R. 7553 would create a simple, flat exemption from the 30 percent tax for interest on all debt obligations of U.S. persons. This naturally would enable United States companies to secure Euromarket funds.

Our proposal would create an exemption only in two carefully defined sets of circumstances. The first would be for "targeted" Eurobond obligations issued after the effective date of the statute. The obligations would have to be obligations that were designated for distributions to foreign persons. In addition, the interest payments would have to be made outside the United States by a paying agent of the borrower. The exemption for this class of issues would be very much like the exemption which existed between 1971 and 1974 for securities issues designated by the borrower as subject to the IET.

In addition, interest payments would be exempt on obligations issued in registered form if the payee certified to the borrower either that the payee was a foreign person and was the beneficial owner of the obligation, or that the payee was a nominee, and that the beneficial owner was a foreign person. A certification by a nominee, however, could only be made by a financial institution in the business of holding securities as a nominee.

The Administration proposal and H.R. 7553 would, we think, be equivalent in terms of their effect. Both would cost about $88 million, the approximate amount we now collect from the interest tax at source. Both would provide direct access to United States borrowers to foreign capital markets.

The principal differences would be in terms of the potential impact of the two measures on the domestic tax enforcement system. We foresee two dangers in H.R. 7553. First, we believe the measure might create incentives to United States corporations to market debt obligations in bearer form in the domestic market in volumes substantially greater than appear today. Most corporate securities presently being issued in the United States bond market are in registered form. By contrast, most bonds sold on the Eurobond market are in "bearer" form. To structure an issue saleable both to American and European buyers, United States companies might have to issue securities in bearer form to all buyers.

This result would have an undesirable effect on our domestic tax enforcement system, because it is more difficult to enforce compliance in the reporting of income from bearer instruments than from registered instruments. We do not wish, therefore, to give borrowers substantial incentives to market securities in bearer form, where none presently exist.

Second, there is a danger that H.R. 7553 would enhance the opportunities of the United States persons to successfully evade taxes by holding interest-bearing securities "offshore." Under existing law, the interest withholding tax and the reporting and certification procedures which go with it create an obstacle to a United States person holding securities through a foreign nominee or at a foreign address and simply failing to report the income on the securities. Under H.R. 7553, the 30 percent tax, and the withholding and certification requirements, would be eliminated for interest payments sent to foreign addresses. There would thus be somewhat greater opportunities than exist today for United States persons to evade income taxes through "offshore" holdings of debt securities.

The limitations in the Administration proposal are designed to avoid these problems. The Administration proposal limits the interest tax exemption to two categories of obligations—obligations which are specially "targeted" to the international or foreign market; and obligations in registered form as to which the owner (or his nominee) certifies that the owner is a nonresident alien or foreign corporation. Under this proposal, bearer securities not specially designated for distribution abroad would not qualify for the exemption. This would obviate the danger of a widespread expansion of the use of bearer bonds in the domestic bond market. In addition, United States persons would not be able to escape detection on interest payments simply by purchasing securities through foreign nominees, or holding them at foreign addresses; to evade tax, they would have to take the additional step of fraudulently certifying—or attempting to cause the bank or securities dealer holding the securities as nominee to fraudulently certify—that the beneficial owner was a foreign person.

In summary, we support a proposal to create an exemption from the 30 percent tax for interest paid to foreign persons. We believe that, if properly limited, such a measure would represent a sound approach, from the standpoint of tax policy, to the taxation of income from international debt investment.

ADMINISTRATION PROPOSAL—EXEMPTION FROM INTEREST TAX AT SOURCE FOR CERTAIN INTEREST PAYMENTS TO FOREIGN PERSONS

Interest paid to nonresident aliens and foreign corporations (other than controlled foreign corporations or persons with a 10 percent or greater interest in the borrower) would be exempt from withholding tax if it were

(a) paid outside the United States by a paying agent of the borrower with respect to an issue, or portion of an issue, of debt obligations issued after the effective date of the statute which was sold under arrangements reasonably designed to ensure that the obligations would be sold only to nonresident aliens or foreign corporations, or

(b) paid with respect to indebtedness issued in registered form as to which the payee certifies to the borrower that the payee is the beneficial owner of the obligations, and is a nonresident alien or foreign corporation, or that it is a nominee of a nonresident alien.

For purposes of (b), a certification by a nominee could only be made by a financial institution or other person engaged in the business of holding securities as a nominee, but the IRS would be authorized to make and publish at any time a determination that any such institution was making inaccurate certification, or was holding or selling securities of a type described in (a) for or to U.S. persons; after publication of such determination, certification would no longer be acceptable from the institution as to which the determination was made.

Obligations free of interest withholding tax would also not be subject to U.S. estate tax.

Other interest would continue to be subject to the requirements of existing law.

H.R. 5847: TAX EXEMPT FINANCING FOR THE ACQUISITION AND REHABILITATION OF HARBOR IMPROVEMENTS

H.R. 5847 would provide for a special application of section 103(b) of the Code where the proceeds of an issue of industrial development bonds are used to acquire and improve an existing wharf facility. Regardless of who used the facilities before and after the issuance of such obligations, the interest on the bonds would be tax exempt. We understand H.R. 5847 is intended to benefit the Tampa Port Authority by enabling it to acquire and expand the Agrico Chemical Company's Big Ben[illegible]hosphate terminal at Tampa and lease it back to a joint venture in which Agrico will own a substantial interest.

The Treasury is opposed to H.R. 5847.

As we currently understand the proposed transaction, if H.R. 5847 is enacted the Tampa Port Authority will issue approximately $69 million of tax exempt industrial revenue bonds, the proceeds of which will be used for the following purposes: (1) $43 million of proceeds will be used to acquire the existing structures and land of the Big Bend phosphate terminal presently owned by the Agrico Chemical Company; (2) $3 million of proceeds will be used to purchase a parcel of approximately 100 acres of land from Agrico; (3) approximately $17.7 million of the proceeds will be used to construct a new, 100,000-ton dry phosphate storage building and related belt conveyors and stacker-reclaimers; and (4) approximately $5.3 million of the proceeds will be used to modify the existing Agrico structure and the existing conveyor system.

Immediately following its acquisition of Agrico's existing facilities, the Tampa Port Authority will lease back these facilities to a joint venture comprised of Agrico and one other industrial user. We understand that Agrico's interest in the venture will be at least 50 percent. The term of the lease will be sufficiently long so that Agrico will not surrender the use of the existing structure during its economic useful life. We further understand that the joint venture, (in form the lessee of the facilities), will treat itself as the owner of the new 100,000-ton capacity structure for tax purposes (and thus will claim investment tax credit and depreciation).

The basic economic consequence of the sale and leaseback of Agrico's existing facilities is that Agrico will borrow against its equity in the existing structure ($43 million) at a tax exempt interest rate. The fact that the legal title in this structure is transferred to the Authority does not alter this conclusion. Because of the term of the lease, Agrico has not surrendered the use of the facility.

It is important to recognize that the current restrictions preventing refinancing of existing facilities with tax exempt bonds are not an absolute bar to tax exempt financing for this project. The construction of the new 100,000-ton dry rock structure and conveyor system can be financed with tax exempt industrial development bonds because a new facility is being provided. It is the acquisition and leaseback to Agrico of the existing $43 million facility which creates the opportunity for financing working capital through tax exempt borrowing.

The underlying economics of H.R. 5847 demonstrate why tax exempt bonds should not be available to provide financing for the acquisition of an existing facility where: (1) there is no change in the substantial user of the facility; (2) that person receives a significant portion of the proceeds of the issue for his interest in the facility; and (3) no significant reconstruction of the existing structure takes place. Whether the tax exempt financing is in the form of a secured borrowing or a sale-leaseback (including a true lease for substantially the useful life of the property), it is, in substance, a form of tax exempt financing for the owner's equity in existing facilities. The tax-exempt financing is in no sense providing any new facilities.

The bill does raise, however, a broader issue which we feel merits discussion—the extent to which tax exempt industrial development bonds should be available to finance the renovation and rehabilitation of exempt facilities.

Current Treasury regulations provide that if the original use of a facility which is permitted to be financed by tax exempt industrial development bonds (in this case, the wharf) commences prior to the date of issuance of the bonds, there are certain restrictions relating to the subsequent use of the facility that must be met. A person who was a "substantial user" of the facility at any time during the five-year period preceding the date of issuance of the obligations and who received, directly or indirectly, 5 percent of the face value of the industrial development bonds for his interest in the facility generally may not be a "substantial user" of the facility at any time during the five years following issuance without the interest on the bonds losing its tax exemption. (Because Agrico is now a "substantial user" of the facility, would remain so after the proposed transaction, and is projected to receive $48 million of the $60 million total bond proceeds for its interest in the terminal, the current regulations bar the use of tax exempt financing.)

The purpose for the restrictions in the regulations is plain. Tax exempt borrowing is permitted for industrial development bonds to provide facilities, and not to permit persons to borrow against existing facilities or refinance taxable indebtedness with tax exempt bonds. Thus, the regulations appropriately bar refinancing with tax exempt industrial development bonds. However, the current regulations also prevent a continuing owner from financing a substantial rehabilitation with tax exempt bonds, but permit the issuance of tax exempt bonds to finance the acquisition of an existing property even though no new facility or construction is provided.

We believe that the distinction drawn by the current regulations with regard to the use of tax exempt borrowing to finance the acquisition and rehabilitation of facilities already in use should be reexamined. We are currently considering the extent to which such borrowing, with appropriate safeguards, should be available to finance the acquisition, renovation and rehabilitation of all types of exempt facilities.

We believe a rational approach to the use of tax exempt borrowing for rehabilitation must strike a balance between the goal of preventing the use of such financing to borrow against existing facilities to refinance, directly or indirectly, existing taxable debt (or to extract the owner's equity) and the goal of allowing a certain amount of rehabilitation of existing facilities even though there is no change in the persons who use them. In accomplishing this latter goal, it must be acknowledged that some bond proceeds will likely be expended to pay off existing debt.

We are currently considering an approach that would bar the issuance of tax exempt obligations for the mere acquisition (with no significant renovation or reconstruction) of a facility which is already in use. That is a clear case in which tax exempt industrial development bonds are used merely to supplant private borrowing. No new facilities are provided for public use. There has only been a change in ownership. There seems little reason to allow tax exempt industrial development bonds to finance such a transaction.

On the other hand, it may be appropriate to permit tax exempt industrial development bonds to be issued for the substantial renovation or rehabilitation of an exempt facility. In the case of a substantial reconstruction or rehabilitation, a facility with a changed or expanded use which benefits the public is provided. In some sense, it can be said to be a "new" facility. Such a change would eliminate the rule of the current regulations which restricts the identity of the persons who can make substantial use of an existing, renovated facility after issuance of the bonds. The new standard might be drawn to require that any issuance of tax exempt obligations to substantially rehabilitate or reconstruct a facility would require that the amount of bond proceeds spent for the rehabilitation equal or exceed some percentage of the facility's adjusted basis or fair market value immediately prior to the rehabilitation or reconstruction. If this percentage were set high enough, substantial renovations could be undertaken without a risk that the obligations would be used principally to refinance an existing taxable indebtedness or to provide working capital through borrowing against the current owner's equity at tax exempt interest rates.

Of course, an extension of tax exempt industrial development bonds to finance rehabilitation without a change in users would require appropriate safeguards. The quantitative standard by which a qualifying rehabilitation might be measured in one such safeguard. The construction of a separate structure, even though it may be integrated into the operations of the existing facility, does not, in our view, amount to a qualifying rehabilitation. On the other hand, a major reconstruction of the existing structure should qualify. The determining factor must be the extent to which the renovation of the existing structure provides a "new" facility. A taxpayer who now owns an apartment building with an equity in the building of $10 million should not be able to borrow against that equity by construction a second building, contiguous with the first and constructed to share certain of its common areas and utility connections, and then issuing tax exempt industrial development bonds to finance the whole complex. Even if some small part of the proceeds are applied to rehabilitate the first building, it can hardly be said that a "new" facility was provided with respect to that structure. With respect to the existing facility, all that was accomplished was the financing of $10 million of working capital for the owner at tax exempt interest rates.

Another safeguard would be the period of time that must intervene between a qualified rehabilitation and the time the property is first placed in service. Any proposal creating incentives to rehabilitate property will, to some extent, encourage the deferral of routine maintenance and repair until it could be financed as part of a qualifying rehabilitation. Such expenses are usually paid out of working capital, and deferral of these expenses may indirectly allow tax exempt borrowing to finance working capital.

We believe that the use of tax exempt borrowing for the rehabilitation of exempt facilities, accompanied by appropriate safeguards, may well be justified in certain cases. Policy in this regard should certainly be reexamined and clarified. We stand ready to work with this Committee, and all interested persons, in examining and clarifying the rules of this area.

H.R. 4176: CERTAIN CONTRIBUTIONS TO FRATERNAL ORGANIZATIONS

Code sections 170, 2055 and 2522 allow a deduction for income, estate and gift tax purposes for contributions or gifts to a domestic fraternal organization, operating under the lodge system, only if the contribution is used exclusively for charitable purposes. Under the bill a deduction would be allowed for Federal income, estate and gift tax purposes for a contribution or gift to a tax-exempt domestic fraternal organization for the construction or maintenance of a building the principal purpose of which is to house the organization. Since tax-exempt domestic fraternal organizations engage in both fraternal and charitable activities, H.R. 7220 would permit a deduction for certain contributions to these organizations that are not used exclusively for charitable purposes.

Under present law domestic fraterial organizations already receive special treatment by virtue of the allowance of a deduction for income, gift and estate tax purposes for contributions that are used exclusively for charitable purposes, even though these organizations themselves are not organised and operated exclusively for charitable purposes. By contrast, a deduction is generally allowed only for a charitable contribution to an organization organised and operated solely for charitable purposes. We believe that the deduction for contributions to domestic fraternal organizations should be limited, as under present law, to contributions that are used exclusively for charitable purposes; therefore, we oppose the expansion of Code sections 170, 2055 and 2522 as proposed by H.R. 7220. There is no reason to allow a charitable contribution for funds used to construct a building used for fraternal purposes.

H.R. 4511: RATE OF TAX ON HOMEOWNERS ASSOCIATIONS

H.R. 4511 would amend Code section 528, relating to certain real estate management and condominium associations ("homeowners associations"), so that tax would be imposed on such associations at the graduated rates for corporations. Currently, the income of a homeowners association is taxed at the "highest rate of tax" for corporations, 46 percent. The Treasury Department is opposed to H.R. 4511 in its present form. However we would not object to the bill if it is modified as I shall later suggest.

Before 1976, it was unclear whether corporations organized as condominum or residential real estate management associations would be treated as exempt organizations or associations taxable as corporations. If taxed as corporations, homeowners who maintained homes through an association would be taxed twice, once when they earned the income and a second time when it was received by the corporation. To alleviate this uncertainty Congress enacted Code section 528 in the Tax Reform Act of 1976.

Section 528 ensures that participants in homeowners associations can arrange to defray collectively the expenses of maintaining their personal residences, without being subjected to more onerous tax treatment than those who paid directly the expenses of maintaining their homes. The section essentially provides that an eligible, electing association will not be taxed on amounts received from members to defray the expenses of maintaining common property. However, this exemption would offer an opportunity for tax advantage if homeowners were permitted to contribute portfolio assets to the homeowners association and use the tax-free income from these investments to defray the expenses of maintaining their residences. Similarly, a homeowners association might be used as a shield for the conduct of an unrelated business, the pretax profits from which could be applied to the maintenance of the participants' common expenses. Accordingly, the statute provides that all income derived by a homeowners association, other than through dues, fees or assessment received from its members, is to be taxed to the association as a corporation.

Before the Revenue Act of 1978, which added the graduated rate schedule for corporations, a homeowners association was taxed on its income without allowance for the pre-1979 surtax exemption. Out of consistency with the statute as it existed before 1979, homeowners associations were not permitted to use the graduated rate schedule. Moreover, the rationale for enacting a graduated corporate rate was to encourage capital formation, particularly by small business. That rationale furnishes no justification for imposing a graduated rate on homeowners association which are not organized as profit-making enterprises.

Taxation of investment or trade or business income of a homeowner association is essentially a surrogate for attributing the income to members of the association and taxing it at their individual marginal rates. Where the average rate of the participants is less than the 46 percent top corporate rate, the income of the association might be said to be "overtaxed." Where the average rate of the participants exceeds the 46 percent top corporate rate, even without the change by H.R. 4511, the association income would, in effect, be undertaxed.

Short of conduit treatment, there is no absolutely correct solution to this problem. Application of the graduated corporate rate would, in many cases, subject association income to tax at rates lower than those of the members and would, therefore, tend to encourage accumulation of investment assets. However, the average tax rate applicable to deductible expenses incurred by those owning homes is 32 percent. Although it is not a perfect solution, we would not object to this bill if the first $75,000 of homeowners association taxable income were taxed at 30 percent, with the graduated corporate rate schedule to apply to income in excess of this amount. Taxation in accordance with this proposed rate schedule would coincide with the graduated rates above $50,000, in addition would, on average, be fairly close to the "correct" rate for income below $75,000. It would also discourage accumulation of investment assets and reduce the incentive which would exist under the graduated corporate schedule to shift income from one year to the next to achieve taxation at a lower rate.

H.R. 4844: ELECTION OF ESTATE TAX ALTERNATE VALUATION

The value of assets included in a decedent's estate is determined, in general, either at the time of the decedent's death or six months after the decedent's death. The latter date is called the alternate valuation date. Under present law an alternate valuation date election must be made on a timely filed estate tax return. H.R. 4544 would permit an executor to elect alternate valuation on the first late return filed.

As the proponents of H.R. 4544 have stated, the estate tax consequences of an alternate valuation election will not change if an election is permitted on a late return. It is also true, however, that an alternate valuation date election will usually have income tax consequences because an heir's basis is, in general, equal to the estate tax value of the property received. An extension of the election date to include late returns may, despite late filing and payment penalties, encourage deferred elections in an attempt to minimize the aggregate estate and income tax consequences to the recipients of inherited property. We would become concerned if such a trend developed. On balance though, we do not oppose the substantive change made by H.R. 4544.

However, we do oppose H.R. 4544 as drafted because of the bill's effective date and transition relief provisions. The bill is effective, in general, for estates of decedents dying after December 31, 1977. In addition, it contains a special transition rule pursuant to which executors of estates of decedents dying before December 31, 1977, could, within 90 days of enactment, perfect a defective alternate valuation date election so long as such an election had been indicated on the first estate tax return filed by the executor.

This transition relief is objectionable on two grounds. First, it is unfair. Second, and this is true also of the retroactive effective date, it will raise administrative problems.

The transition rule is unfair because it will reward those who attempted to elect alternate valuation in clear contravention of the statute. It will not, however, afford relief to those who filed late returns and, cognizant of the fact that an alternate valuation election was prohibited under the circumstances, did not attempt an election even though it would have benefited the estate. Nor does it afford relief to those who did not elect alternate valuation on timely filed estate tax returns in circumstances where, if additional time had been available to gather the necessary valuation data, an alternate valuation election on a late return would have benefited the estate.

The uneven application of the transition rule can be partially rectified by granting all executors who filed late returns a limited time period within which to amend previously filed returns to elect the alternate valuation date. However, the problem cannot be totally solved short of granting all executors a limited time period within which to reconsider whether an alternate valuation date election was appropriate.

Retroactive relief in either form would result in administrative difficulties. First, there would be problems of notice to affected executors. Closed estates may have to be reopened. Second, if an executor retroactively elected the alternate valuation date every heir would have to be notified of the income tax basis change in assets which had been distributed. Moreover if there had been interim sales of property included in a decedent's estate, amended income tax returns reflecting the change in basis would have to be filed. These problems are all avoided if the bill is prospective. Therefore, we strongly recommend that the retroactive effective date and special transition relief be deleted from the bill.

H.R. 4640: EXCEPTION FROM EXCESS BUSINESS HOLDING RULES FOR INDEPENDENT LOCAL NEWSPAPER BUSINESS

Under current law, a private foundation's ability to own a business enterprise is limited by the Internal Revenue Code (section 4943). In general, the maximum permitted holdings are twenty percent of the voting stock of the business enterprise reduced by the percentage of voting stock owned by certain related parties referred to as disqualified persons. The amount of permitted holdings is increased to thirty-five percent if effective control of the enterprise is in persons who are not disqualified persons with respect to the foundation. If the foundation's holdings in the business enterprise are increased above the level of permitted holdings other than by purchase by the foundation or by a disqualified person, for example by gift or bequest to the foundation, the foundation has five years within which to bring its holdings down to a permitted level. Special rules provide extended disposition periods for private foundations which had excess business holdings on May 26, 1969. The limitations on excess business holdings apply to all private foundations and to all types of active business except those functionally related to the exempt purpose of the foundation.

H.R. 4640 would exclude an independent local newspaper business from the definition of business enterprise contained in section 4943. An independent local newspaper is defined as a newspaper publication which is not one of a chain of newspapers and which has all of its publishing offices in a single city, community, or metropolitan area, or, on January 1, 1979, within one state.

In effect, the bill would permit a private foundation to own an independent local newspaper business indefinitely, notwithstanding the generally applicable excess business holdings provisions described above. We understand that H.R. 4640 is intended to benefit the Houston Endowment, Inc., a private foundation which owns 100 percent of the stock of the corporation publishing the Houston Chronicle.

The rationale advanced for the bill is that the estate tax liability of deceased owners of independent local newspapers can be met only if the newspaper is sold and that the only available purchasers are large newspaper chains. The alternative of bequeathing the newspaper business to a private foundation does not change this result because the private foundation must in turn dispose of most of its interest in the business within five years. However, if a private foundation could retain ownership of the newspaper business indefinitely, no forced sale would occur and the existence of a broad-based independent free press would thereby be encouraged.

The Treasury Department opposes H.R. 4640. First, we do not believe that a special exemption from the excess business holdings provisions for independent local newspaper businesses can be justified. These provisions are no more onerous for newspaper businesses than they are for any other type of business. To allow a special exemption for newspapers under an independent free press rationale would open the door to riddling the excess business holdings provisions with similar exemptions. Moreover, the concerns underlying the enactment of the excess business holdings provisions—and, in particular, the concern that a private foundation which owns a business has an unfair competitive advantage because of its tax exemption and because of its lesser concern with maximizing its profits—certainly apply to the newspaper business.

Second, we do not agree that the estate tax necessarily forces the estate of the owner of a newspaper business to sell the business. There are a number of estate planning alternatives which could obviate the need for selling the business, including a redemption pursuant to section 303; payment of the estate tax in installments pursuant to section 6166 or 6166A; deferral of the estate tax under section 6161(a)(2); purchase by the owner of sufficient life insurance to pay the estate taxes; borrowing by the estate to pay the estate tax using the stock as collateral; or sale of the stock to an employee stock ownership plan (ESOP) established by the corporation.

Finally, to the extent the estate tax does pose special problems for the owners of businesses, these problems should be addressed by legislation covering all businesses, not by special exemptions for particular types of businesses.

H.R. 5512: EXCEPTION FROM PRIVATE FOUNDATION "SELF-DEALING" RULES FOR CONTINUATION OF CERTAIN LEASES

H.R. 5512 would except from the private foundation "self-dealing" rules the leasing by a "disqualified person" to a private foundation of office space if (i) there were other tenants in the building who were not disqualified persons; (ii) the leasing were pursuant to a binding lease which was in effect on October 9, 1969 or pursuant to renewals of such a lease; (iii) the execution of the lease were not (at the time of execution) a "prohibited transaction" under section 503(b) (or any corresponding provision of prior law); and (iv) the space were made available to the foundation on a basis no less favorable than on which the space would be available in an arm's length transaction. Under a ten-year transitional rule, the leases covered by the bill are currently excepted from the self-dealing prohibitions until taxable years beginning after December 31, 1979. The bill would, in effect, except such leases from the self-dealing rules indefinitely.

We understand that H.R. 5512 is intended to benefit the Moody Foundation of Galveston, Texas. However, the bill would also apply to any other private foundation having a lease which meets the conditions of the bill.

Although, in general, we would oppose the creation of a special exception to the private foundation self-dealing rules, there are several elements of this bill that make it less objectionable from our point of view.

First, the bill does not create a permanent exception to the self-dealing rules The exception provided by the bill will in effect be limited by the useful life of the building in which a foundation was leasing office space in 1969.

Second, since the bill requires the building to have other tenants who are not disqualified persons, there would be a basis for comparing the foundation's lease terms in order to ascertain whether the foundation's terms were comparable to an arm's length transaction. Thus one rationale of the self-dealing rules—that a prophylactic rule forbidding potential self-dealing transactions is necessary because it is too much of an administrative burden for the Internal Revenue Service to determine whether these transactions are fair to the foundation—would not necessarily apply.

Finally, we understand that, in the case of the Moody Foundation, there is no other suitable building in town other than the one in which they are presently leasing office space from a disqualified person.

Because of this rather unusual concatenation of circumstances, the Treasury Department does not oppose H.R. 5512.

H.R. 7220: TWO-YEAR EXTENSION OF TIME TO AMEND THE GOVERNING INSTRUMENTS OF CHARITABLE SPLIT-INTEREST TRUSTS

The Tax Reform Act of 1969 imposed new requirements that must be met in order for a bequest or gift of an income or remainder interest in trust to qualify for a charitable deduction for income, gift, and estate tax purposes. In the case of a remainder interest in trust, the interest passing to charity must be in either a charitable remainder annuity trust, a charitable remainder unitrust, or a pooled income fund. In the case of an income interest passing to charity (i.e., a charitable lead trust), the income interest must be either a guaranteed annuity or a fixed percentage of the fair market value of the trust (determined at least annually).

The provisions of the 1969 Tax Reform Act regulating charitable "split-interest" trusts were enacted to ensure that the charitable deduction allowed was consistent with the amount the charity ultimately would receive. However, it soon became apparent that some persons had inadvertently created instruments that failed to meet the new requirements. In many of these cases the burden of the increased tax resulting from the disallowance of a deduction was borne by the charity. When this occurred the amount ultimately received by the charity was less than it would otherwise have been if the interest had qualified for the deduction.

In recognition of these problems, Congress, in 1974, enacted section 2055(e)(3) which permitted certain defective charitable split interest instruments to be reformed prior to December 31, 1975, to meet the statutory requirements for an estate tax charitable deduction. The time period within which a reformation was permissible was subsequently extended to December 31, 1977. The Revenue Act of 1978 extended until December 31, 1978, the time to amend instruments establishing charitable remainder trusts which were executed before December 31, 1977. In addition, the 1978 Act provided that similar rules were to apply for income and gift tax purposes to charitable lead and remainder trusts which were created before December 31, 1977, and amended (or judicial proceedings to amend were commenced) by December 31, 1978. H.R. 7220 would extend the December 31, 1978 date in the 1978 Act to December 31, 1980.

At some point it might be appropriate for Congress to say that taxpayers can no longer have an opportunity to reform defective charitable split-interest instruments. However, experience has shown that isolated cases of inadvertant error will continue to arise. Moreover, these cases will often present compelling arguments for relief, particularly where the increased tax burden is ultimately borne by the charitable beneficiary. Thus, while we do not oppose H.R. 7220, we are interested in devising a permanent provision that will permit conforming amendments to be made to instruments created by those who have made a good faith effort to comply with the charitable split-interest rules. We have been working with the Joint Committee Staff and interested members of the public to develop such a proposal. We hope to be able to present it to the Committee before this session ends.

I would be pleased to answer any questions you may have.

Mr. Rostenkowski. Thank you, Mr. Lubick.

On the nonresident alien legislation that I have introduced at Treasury's request, the bill permits corporate bonds to be issued to foreign bondholders. As I understand it, you wish to have this changed so that the identity of foreign bondholders not be disclosed to the Internal Revenue Service. Does that imply, Mr. Lubick, that those foreign bondholders will not pay tax on the interest to anyone?

Mr. LUBICK. Well, that of course is an obligation between the foreign bondholder and his own government. Certainly, there is tax evasion that exists in the United States which arises because of the receipt of interest on obligations in bearer form. We do not have information reporting on bearer obligations here. It exists in foreign countries. In some of the foreign countries there is no tax on this particular source of income; it depends on the country involved. But, as a practical matter, Mr. Chairman, we find that this entire Eurodollar market operates on the basis of bearer securities.

What we are concerned with and, I think, what is the concern of the United States, is that we not give any additional opportunties to Americans to avoid their tax obligation through participating in this market. That is why we have suggested a limitation on the exemption to issues that are targeted and follow the SEC rules to insure that they go to foreigners.

I do not think we are adding one whit to or subtracting one whit from how foreigners are going to deal with their own governments. That is not our concern. But we have put the restrictions that we have suggested in our proposal, especially as compared to the Senate Finance Committee reported proposal, to minimize—and we cannot eliminate it completely—the ability of Americans to use these obligations. We are limiting it to obligations that are intended for foreigners. The situation with respect to these foreigners will be no different as to how they satisfy their obligations to their home governments whether we pass the legislation or whether we do not pass the legislation. We have enough problems dealing with the compliance of American taxpayers without having to take on compliance responsibilities for all of the other countries of the world that are involved.

We would be very pleased to sit down with all of these countries and engage in an exercise to produce a worldwide agreement to assure compliance by all taxpayers with the laws of their countries. I do not see that happening immediately. But our proposal does nothing to add to noncompliance, and in fact it does, we believe, give an assist to solving our own noncompliance problem by limiting somewhat the ability of Americans to acquire these bearer obligations.

As far as the registered obligations are concerned, we have also improved our ability to prevent noncompliance by Americans by setting up a certification procedure which does not exist at the present time. So, we think we will have taken a step—not a major step, but some step—forward on the problem of noncompliance by Americans.

Essentially, what we have tried to do is to make this provision neutral vis-a-vis the compliance situation. We have not tried to solve problems of noncompliance. We have tried and we have succeeded in not increasing any opportunities for noncompliance. That was our objective. We did not regard this as a great reform bill in terms of collecting everybody's taxes throughout the world.

Mr. **Rostenkowski.** Mr. Lubick, if we stopped trying to properly collect information, why would foreign governments assist us in assuring that our citizens pay taxes on their income outside the United States?

Mr. **Lubick.** Well, we are not ceasing to collect information. At the present time, Mr. Chairman, we have obligations under treaties. But the fact of the matter is that you have a foreign investor who insists on anonymity. He will find a vehicle—and there are plenty of them available today—to protect his anonymity. We are not diminishing in any respect the flow of information to anyone seeking to enforce compliance. Any foreigner who is insisting on anonymity for purposes of evading the taxes of his particular country can purchase bonds issued—if they are U.S. obligations—through a finance subsidiary organized under the laws of one of the jurisdictions with which we have treaties. He can go through Switzerland, where there is anonymity. We simply have not been able to make any change in that problem in this bill. We have not aggravated it and we have not made it worse. We have not significantly ameliorated it. We have not ameliorated it at all except as far as Americans are concerned.

But this is not the vehicle to deal with the compliance problems. We want to make sure we have not made the problems worse, but this was not intended as a measure to solve world-wide compliance problems.

Mr. **Rostenkowski.** Are there questions of the Secretary?

Mr. **Duncan.** I have a question.

Mr. **Rostenkowski.** Mr. Duncan.

Mr. **Duncan.** Thank you, Mr. Chairman.

Mr. Secretary, I have not seen your testimony, but from statements I have heard your position seems to be to disregard the fact that organizations must have buildings for charitable activities. We encourage charitable activities, but unless they have proper buildings they cannot carry out the function for which they were intended. Do you have any comment on that?

Mr. **Lubick.** Well, that is true, Mr. Duncan, if the organization is a charitable organization. But the organizations which are the subject of H.R. 4175 are not exclusively charitable organizations.

To the extent that a contribution is made for use exclusively for charitable purposes, a contribution deduction is already allowed. The bill would expand the allowability of a charitable contribution deduction to where the purpose goes beyond charitable purposes. That is what we think is inappropriate.

If the fraternal organization set up a separate entity which had a separate building which was exclusively used for charity, I suppose it would be eligible under existing law. But I do not see any justification for allowing a charitable contribution deduction where we go beyond the use of the proceeds for charitable purposes. That defeats the function for allowing a charitable contribution deduction and we do not have a particular Federal policy to subsidize noncharitable activities.

Mr. **Duncan.** I do not see that there would be a great revenue loss to the Federal Government if you are encouraging them to do something they would not ordinarily do.

Mr. **Lubick.** Well, ordinarily, I would assume that a fraternal organization—which by hypothesis must be engaging in activities other than charitable activities, otherwise it would be eligible for the deduction and would not need any change in law—is going to have its own headquarters.

The Federal Government, which has an interest in encouraging charity, subsidizes charity through the contribution deduction. That is an activity the Federal Government is not able to do well itself and we want to encourage the private sector to engage in charity. But to go beyond that, to encourage and subsidize a fraternal organization to do those activities which are not charitable, simply goes beyond the policy.

Mr. DUNCAN. That just is not happening, anyway.

Mr. LUBICK. This is not going to be a "budget buster," but it seems to be an inappropriate principle.

Mr. DUNCAN. Well, I find the administration feels that everything is an inappropriate principle.

You alluded to tax-free bonds. It is my understanding that the administration actually advocates tax-free bonds by municipalities and States for energy-saving devices or plants such as coal gasification plants; is that correct? Are you opposed to those kinds of tax-free bonds?

Mr. LUBICK. We generally are opposed to expansion of industrial development bond financing. Now, we recognize that there are a number of categories as to which industrial development bond financing is permitted. We think we would all be better off if tax exempt financing were limited to governmental functions of State and local governments, and we did not have any industrial development bonds; that would be an ideal world. Then we could encourage these particular activities that we think are desirable, if we wanted to do it, through the tax system. We could do it through a system of credits or some other way.

If we wanted to encourage certain activities and this were done through other subsidies that were on budget and that would be scrutinized for their effectiveness, we think that would be desirable. Tax exempt financing as a way of subsidizing private industrial activity is highly inefficient. It is deleterious to State and local governments; it drives up their cost of financing. It makes for an increase not only in Federal income taxes—because we have this off-budget type of subsidy as to which there is great leakage to both high-income taxpayers and investment bankers—but also in taxes of State and local governments which have to finance the debt service on their governmental obligations.

In point of fact, the situation got so bad in 1968 that the State and local governments supported the Congress and the Treasury Department in putting a curb on industrial development financing. As so often happens, a pure line was not drawn. A number of categories were set up dealing primarily with activities that are quasi-governmental. That is why industrial development bonds may be used to finance airports, docks, wharves and a number of other categories that are very close to governmental activities.

There are some categories that are not close to governmental activities, and then there is one special category for small issues, which was raised in the 1978 act to $10 million, which is allowed for industrial development bond financing of any private commercial activity. We read that this has gotten out of hand, too. It is being used to finance medical buildings and professional offices, grocery stores, and all kinds of other activities that do not involve the industrial development of a community.

Mr. Duncan. I do not wholly disagree with you on all your views on that particular thing. What I was saying was that the administration and the President is encouraging the issuance of industrial development bonds for, let us say for example, a coal gasification plant. You have not been opposed to it?

Mr. Lubick. Mr. Duncan, it is said that some are born great and others have greatness thrust upon them. I think this is a case where you thrust this particular provision on us. I do not think we ever encouraged the expansion of tax-exempt financing for these purposes. We have been trying to beat an orderly retreat here on these encroachments, and we think the problem has gotten so serious that it is a great problem for the whole Federal budget process. We are approaching a crisis time during which we are going to have a very hard time dealing with the outlays. We want to keep the percentage of gross national product that is being run through the Federal sector and the tax system down.

If we continue to proliferate these inefficient expenditures through tax-exempt financing, we think it is going to be very difficult to achieve the economic stability which we need, and it is going to result only in more deficits, more inflation, and fiscal disaster.

That is why we are very anxious to hold the line. If we can get some rollback in this whole area of tax-exempt financing, I think that would be a very constructive thing.

Mr. Duncan. I think it is going to be interesting, the President's energy message on July 4, to see what he does recommend. It may be the same as the Defense budget, he recommends a stronger defense with less money.

Mr. Lubick. We can certainly give you more of anything with less money if we can get rid of the tax-exempt financing.

Mr. Duncan. I disagree with you. I do thank you, though.

Mr. Rostenkowski. The time of the gentleman has expired.

Mr. Duncan. Thank you, Mr. Chairman.

Mr. Rostenkowski. Mr. Guarini will inquire.

Mr. Guarini. I am very concerned about the unevenhandedness of some of the philosophy that is being exhibited here. You very vehemently oppose housing bonds where working people would be able to get the benefit of tax-free bonds so that they would have the advantage of lower mortgage interest rates and would be able to buy a home in our country. Yet, you would give tax-free status to foreign corporations. That seems inconsistent to me.

We are talking in terms of having in both Houses, with reconciliation of the budget, a capital gains tax imposed on foreign corporations and nonresident aliens because we feel that we are treating the American citizens differently and putting them on a second level, under foreigners, by giving foreigners situations where they pay no capital gains tax. Now, we are about to make them pay a capital gains tax under our reconciliation proposal, and immediately you are proposing repealing the 30 percent on corporate bonds. So, we are going in two different directions with our own people and we are going in two different directions with nonresident aliens and foreign corporations.

Now, I always thought that we were not, as a matter of philosophy, going to encourage tax haven countries and tax haven operations. This proposal encourages offshore corporations. It is not just a matter of speaking in terms of foreigns, but in terms of the encouragement we are going to give our own people to form corporations in the Grand Cayman Islands and St. Vincent Island and all those other places where with bearer bonds they can play the same game that you make now legal for nonresident aliens and foreign corporations. There is tremendous inconsistently here.

We are talking about placing withholding taxes on interest and dividends for our own citizens. Yet, here you are saying that foreigners do not have to pay any withholding tax nor any tax at all. I just cannot understand what direction the Treasury is coming from.

We do have an OIO that does have the responsibility of working out any kind of evasions by our own citizens and dealing with foreign countries, and getting the cooperation of foreign countries when we are talking about the evenhanded application of our tax laws. But everything you are saying here is inconsistent with everything I believe. I would like you to respond to that.

Mr. LUBICK. Mr. Guarini, I think one of our problems is our unerring, undeviating consistency; that is how we get into so much trouble. Basically, housing bonds do not involve interest-free bonds for working people. Working people do not buy those bonds.

Mr. GUARINI. They get the benefit of it because they get an 8-percent mortgage instead of, maybe an 11-percent mortgage in the long term, in buying a house. They are the beneficiaries of that system.

Mr. LUBICK. We have never opposed helping people to acquire low-cost financing or assistance to get housing. What we have opposed—and I do not think this is the time to continue the mortgage subsidy bond debate which went on for many months—but what we have opposed is an inefficient, uncontrolled off-budget method of financing that by 1984 would spray some $12 billion of revenue loss to persons other than these working people. If we took that $12 billion and gave it to the working people to enable them to buy homes, we would have one heck of a lot more people in homes in this country. We are trying to achieve a reasonably efficient way of doing it.

Mr. GUARINI. Would you yield for a moment? Our housing market has never been lower than it is today. It was getting along fine until we knocked the props out from the one segment of our housing market that was going great. You could have limited it, but you preferred instead to knock it out entirely.

It is only because of the pressures that were put on by the committee that we even got a halfway bill through.

What I am saying is that your entire philosophy in the Treasury Department should be consistent with the best interests of the people of our country, our working people. Instead, it is consistent with the best interests of the large corporations, the foreign corporations, and the people who seem to be running our country.

Mr. LUBICK. I do not think that is true, Mr. Guarini. Basically, we will take any amount of money that the Congress deems appropriate to spend on housing, and we would suggest that, once that decision has been made, it be spent in the most efficient way so that it all goes to provide housing and does not go to investment bankers, does not go to high income taxpayers, and does not drive up the cost of State and local borrowing.

I do not think we disagree in the objective that we want to reach, and I think you would agree that we would want to get there in the least expensive, most efficient way.

Mr. GUARINI. I will give you another example. In regard to the average citizen borrowing on his plastic credit cards, you have eliminated it. But you absolutely help in every way by this bill to give credit and borrowing capacity for large corporations. So, the individual, the poor working guy, he is the person who does not get the credit, but the credit is given to large corporations for their purposes.

This is certainly an "investor's bill" and it is certainly a bill that favors the large corporations.

Mr. LUBICK. Let me say two things, Mr. Guarini. What is most harmful to the working person in this country is the fantastic rate of inflation that we have had. That is putting an unbearable squeeze on him, and this is generally recognized. If we do not get inflation under control, the working person is going to be worse and worse off because inflation is most cruel to those persons who are least able to bear it.

Now, as far as large corporations that may have access to capital markets are concerned, this legislation is not going to change that in any respect. The large corporations today, as you pointed out, are tapping these markets through tax haven countries. If anything, this legislation, by permitting direct borrowing—borrowing which is taking place already—is going to minimize the use of tax haven jurisdictions and to minimize the use by Americans of tax haven shelters. If anything, this is going to help that problem.

Mr. GUARINI. One last question, I know my time has run out. You cannot get into a complicated matter like this in the few minutes that you have to interrogate.

What is to stop an individual now who forms an offshore corporation some place and pays bearer bonds, and then invests all his money through that overseas operation that he set up himself, so that he can take advantage of being a foreign corporation. What is to stop him? Have you not legitimized that situation?

Mr. LUBICK. This legislation does not do that, Mr. Guarini. This legislation will enable us to deal with this problem because we will be able to have some control by substantially limiting these benefits to foreigners, and we will be able to negotiate treaties that will deny their benefits to Americans. This is our treaty-negotiating policy, to have treaty benefits limited to residents of the treaty partner country, and not to be used by third parties.

I think that is consistent with the position you are taking. If anything, this legislation will enable us to achieve that result.

Mr. GUARINI. Do you think we are going to get a treaty with some of these tax-free havens, Liechtenstein, some of those other places, that is going to be against their interests?

Mr. LUBICK. We are making real progress in that area and there will be some press releases on two jurisdictions within the next week.

Mr. GUARINI. Thank you.

Mr. ROSTENKOWSKI. Mr. Holland?

Mr. HOLLAND. Thank you, Mr. Chairman.

Mr. Lubick, with reference to 7553, yesterday the Ways and Means Committee took some action that would remove favorable tax treatment for foreign investors, basically, in real estate in the United States. I presume that action has the support of Treasury.

Now, this bill purports to extend favorable tax treatment to foreign investors. It seems to me to be contradictory. Would you comment on that?

Mr. Lubick. Yes. You are dealing with two different markets there, Mr. Holland. Essentially, when we are dealing with international debt capital you are dealing with an integrated market where capital flows back and forth across international borders, based solely on the rate of return. In order to avoid tax barriers in that market we are suggesting that the country of residence of the taxpayer determine the tax burden in that regard.

When you are dealing with international capital, the market is the world. It is the flow of capital, certainly in the developed countries, across borders.

When you are dealing with U.S. real estate, the basic situation is that the market is U.S. real estate and the competition in that market is not French real estate, or Italian real estate, or Saudi Arabian real estate——

Mr. Holland. If I could interrupt you, I understand the distinctions. But it seems to me that the overall thrust of yesterday's action was to create a disincentive to foreign investment, and it seems to me the philosophy behind this bill is to create an incentive. I just wonder how this is going to be viewed by the international capital markets.

It seems to me on its face to be contradictory. The philosophy of this bill does not seem to fit into the philosophy of our brave action yesterday to tax foreign investors.

Mr. Lubick. I do not think that is correct. First of all, as I indicated, about 95 percent of interest is already exempt for one reason or another. There are statutory exemptions and there are treaty exceptions, so that as a practical matter you and the Congress have already made a philosophical decision that this ought to be exempt. What is left is a very small tail on a very large dog that is still subject to taxation.

In point of fact, I would suppose that those who pay the tax on interest are largely those who are either ill informed or are in a situation where they are indifferent as to the taxation because they are going to get a credit in their home country. So, basically Congress already made that decision.

Now, in the real estate situation, it is the almost universal practice to have income from real estate taxable in the jurisdiction of the situs. It is probably a pretty good general rule of law in all areas, as I am sure you are aware, that the jurisdiction of the situs is the primary jurisdiction to exercise sovereignty in taxation and other matters with respect to real estate. That is true in State taxation; it is true in international taxation.

But, as we testified earlier before this committee, in the case of real estate, we were involved in a number of abuse situations where foreign taxpayers were electing to have U.S. taxation on their real estate income on a net basis during the time they held the real estate because they were able to take depreciation deductions and utilize other ways of avoiding taxation. Then, when they wanted to sell the real estate, they terminated this election to avoid U.S. tax on the sale. By providing for taxation of capital gains on U.S. real estate in accordance with conventional international practice and in response to a situation where foreign investors are in competition with U.S. buyers of real estate, we are providing a much more orderly and sensible approach.

Now, we will, of course, in some situations negotiate treaties and perhaps make some reciprocal concessions with other countries. But the taxation of real estate has always been regarded as a matter for the jurisdiction of the situs in conventional law and in conventional tradition.

You will find that in very many countries, with respect to interest, the opposite is true. I think what we are trying to do with both of these bills is to place our tax policy on a basis generally consistent with that of most of the developed world.

Mr. HOLLAND. Finally, I have information that the securities industry submitted some revision on 7553. On the face of those, they appear to be consistent with what you want to accomplish. Would you comment for the record on whether or not you have examined these revisions and if you have, what, if any, objections you have?

Mr. LUBICK. Well, I am not sure that I have all the details of their statutory draft. We had a number of meetings with that industry and I can tell you that most of the modifications that they have submitted have been at our instance. I would hope they would be consistent with our proposal as described on page 8. The reason for our proposal was, as I explained to the chairman, we wanted to be absolutely sure that this legislation would in no way adversely affect the existing situation with respect to noncompliance with the U.S. tax laws. The changes that have been made in our proposal are designed to deal with that situation. I would hope that they are consistent. I believe they are consistent because they have been made under pressure from us, at our instance, to assure no aggravation of the noncompliance problem that we have in this country.

Mr. HOLLAND. Thank you, Mr. Lubick. Thank you, Mr. Chairman.

Mr. ROSTENKOWSKI. The alternative valuation date bill, H.R. 4544, do you know of any way to equitably draft this bill to cover the admittedly sympathetic case that is presented in this legislation?

Mr. LUBICK. Well, sure, we could equitably cover it by giving the same benefit to everybody involved, going back several years. That would mean we would have to reopen all of these estates, however, and we would have an administrative mess and a nightmare. We can solve the equity problem at the expense of general retroactivity and much administrative difficulty.

Mr. ROSTENKOWSKI. That is not helping too much, is it?

Mr. LUBICK. No. Maybe we could send the matter to the Judiciary Committee and have a private relief bill to cover that situation.

Mr. ROSTENKOWSKI. I thought that might be the solution you would come up with.

Mr. Lubick, on the Tampa Port bond bill, Treasury, in my opinion, seems to have hardened its opposition to the Tampa Port bill. I read your testimony in the Senate and since that time I note a change in attitude. Why is this taking place?

Mr. LUBICK. Well, we have maintained a constant position, Mr. Chairman; it is only the facts that have changed. We are still going to try to work out rules that would permit substantial rehabilitation to qualify, and would distinguish those from acquisitions of existing facilities.

Unfortunately, because of the short notice, we had about 1 day to prepare our testimony for the Finance Committee, and at that time we did not have full knowledge of the situation in that area. I believe that, before the Finance Committee, we were opposed to legislation and we are still willing to make the change that we suggested at that time, in the regulations. We intend to do that anyway.

The only question is whether the factual situation will come within those principles that we articulated before the Finance Committee. We are opposed, in any event, to any liberalization of the statute which would permit the use of tax exempt funds simply for refinancing, for working capital, the acquisition of existing facilities.

The purpose of the carefully articulated limits on tax exempt financing was simply to enable the provision of certain quasi-governmental facilities—docks, wharves, airports, stadia and the like. If something new would be provided, there is some basis for the tax exempt financing, but if no new facilities are being provided, there should not be tax exempt financing. That is a line that should not be crossed because once you cross that line you take another quantum leap in proliferating tax exempt financing. It is going to be impossible to hold the line.

Mr. ROSTENKOWSKI. Thank you, Mr. Lubick. If there are not further questions I want to thank the Treasury Department for a very lively morning, thus far.

The Chair would like to observe the presence of the Chinese Minister of Health in the room. Would the Chinese Minister and his group please stand? [Applause.]

Mr. ROSTENKOWSKI. At this time the Chair will recognize a very learned colleague who has decided not to stay with us in the decade of the 1980s, the chairman of the Trade Subcommittee, my good colleague Mr. Vanik, for the purpose of making a statement.

STATEMENT OF HON. CHARLES A. VANIK, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OHIO

Mr. VANIK. Mr. Chairman, I ask unanimous consent that my full statement on the bill H.R. ?553 will be inserted in the record in its entirety, and I would just like to make a brief comment, if that unanimous consent is granted.

Mr. ROSTENKOWSKI. Without objection.

Mr. VANIK. Mr. Chairman, I want to point out that I must oppose this dreadful legislation. Over 4½ years ago Congressman Fisher and I spoke on the House floor against repealing this tax which Treasury would like to have us repeal at this time. I think that action which we took 4½ years ago should certainly be followed through today. It is incredible that the Treasury should ask us to impose further withholding requirements on American citizens and let the foreign investments in America escape taxation. I do not think we should compete with the rest of the world in establishing tax havens. We should do other things with investment in America.

I would urge the distinguished chairman of the select subcommittee to guard very carefully against the treaty approach to tax problems. I think the treaty approach is an invasion of the constitutional authority of the Ways and Means Committee to deal with the issue of taxation. I hope that he will insist on his jurisdiction and eliminate the process by which diplomats work out the tax laws of the United States. That is the burden and the responsibility of this very, very important subcommittee.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF HON. CHARLES A. VANIK, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OHIO

Mr. Chairman, I am appearing before the Subcommittee today in opposition to H.R. 7553, which would repeal the 30 percent withholding tax on interest paid to foreign investors. Over four and a half years ago Congressman Fisher and I spoke on the House floor against repealing this tax. The proposal was rejected in the House by a vote of 301 to 119. The case against repeal is even stronger today.

Currently a U.S. withholding tax of 30 percent is imposed on investment payments such as interest, dividends, rents and royalties by U.S. persons to foreign investors if the payments are not connected with a U.S. trade or business. Consideration of tax equity and fairness—as well as maintaining a consistent economic policy—should lead the members of this Subcommittee to reject the new Administration proposal.

The majority of investment income is already tax free. A table contained in the Joint Tax Committee print (page 12) shows that the effective U.S. withholding rate on portfolio interest paid to foreigners is 4.7 percent, far below the statutory rate of 30 percent. It is inequitable to exempt foreign lenders from tax on U.S. interest income while continuing to tax interest received by U.S. lenders. It is a slap in the face to all Americans that the Administration would offer this proposal at a time when they are pushing the Ways and Means Committee to accept withholding on interest to our own investors. A great deal of interest payments to foreigners on U.S. indebtedness will remain tax free even if we reject this proposal. But we should not discriminate against U.S. savers and investors by repealing this vestige of taxation on foreign portfolio income. We should not saddle the American taxpayer with a higher tax burden while foreign investors escape any U.S. taxation on their investment income.

The argument that we can increase U.S. capital formation by repealing the withholding tax is false. The only effect on investment here, if any, will be switching between investments. In addition, to the extent that there is an increase in investment, it will run counter to the stated Administration policy to restrain the availability of credit to reduce inflation. Because of the volatility and freedom of capital markets and offshore banking, repeal of the withholding tax would make control over the nation's money supply more difficult. For example, repeal would make it possible for foreign banks to lend to U.S. borrowers from nontreaty tax haven countries without payment of either the regular corporate tax or the withholding tax. In short, repeal would not significantly increase foreign investment, and would discriminate against U.S. investors and run counter to the Administration's present economic policy.

Finally, maintaining the withholding tax on foreign investment income will help prevent the development of the U.S. into a tax haven. If investments are to continue to enjoy a high degree of security, then the investors should pay some small tax contribution for that privilege. Our business community and country can survive without "hot money" in search of a tax haven. Other nations of the world look to us to lead the battle against tax evasion. To accept repeal would be a signal to these countries that we are giving up without a fight. Withholding at source and complete disclosure is the only effective way to prevent tax avoidance and evasion. Without complete information reporting the U.S. will become a depository for illegal money from around the world—whether it is a German avoiding income taxes, an Italian breaking currency restrictions or an American "cleaning" money from criminal activities.

Based on good tax and economic policy, I ask the Members of this Subcommittee to reject the Administration's contradictory proposal. Thank you for the opportunity to testify.

Mr. ROSTENKOWSKI. Thank you, Mr. Vanik.

The Chair will now ask the gentleman from Texas, Mr. Pickle, and the gentleman from Texas, Mr. Brooks, to take the witness stand.

Very rarely do we, ladies and gentlemen, have the distinct pleasure of having two of the most outstanding Members of the Congress testify before our subcommittee. Certainly, if I yield to my colleagues we will take up too much time with the accolades that could be presented. So, without further comment, the Chair and committee certainly are honored to have with us today two of the most distinguished Texans in the U.S. House of Representatives.

Mr. Brooks, if you are ready, the committee is ready to accept any observation and testimony you might have as well as from our dear colleague, Mr. Pickle.

STATEMENT OF HON. J. J. PICKLE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS, ACCOMPANIED BY MICHAEL WYLIE AND ROBERT BAKER, MOODY FOUNDATION, GALVESTON, TEX.

Mr. PICKLE. Mr. Chairman, Mr. Brooks and I concur in your statement. [Laughter.]

We ask also, Mr. Chairman, if we may have at the witness table Mr. Michael Wylie and Mr. Robert Baker, who represent the Moody Foundation.

Mr. ROSTENKOWSKI. Without objection, so ordered.

Mr. PICKLE. Mr. Chairman, the bill that I have introduced, H.R. 5512, which provides for the leasing by a disqualified person to a private foundation of office space for use by the foundation in a building in which there are tenants who are not disqualified persons.

The bill was introduced to give some assistance to the Moody Foundation because the law which we passed some 10 years ago would have made it impossible for them to continue leasing a building for their own fundation. There are three provisions that must be met if this bill is enacted. That is, the lease would have to be in effect in 1969; it must not have been a prohibited transaction at that time when the lease was effected; and if a lease was made it would have to be at both market price or at "arm's length."

Under the provisions of the foundation this foundation has to be domiciled in Galveston, Tex., where they attempt to lease the building, and there is no other suitable building available.

Now, Mr. Brooks, the distinguished chairman of the Government Operations Committee represents the congressional district where the Moody Foundation is located. If I may, Mr. Chairman, I would like to yield to Mr. Brooks to introduce the gentlemen with him, and for any of us then to answer any questions you might have.

Mr. ROSTENKOWSKI. Welcome, Mr. Brooks.

STATEMENT OF HON. JACK BROOKS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

Mr. BROOKS. Thank you very much, Mr. Chairman. May I put a statement in the record and just comment very briefly?

Mr. ROSTENKOWSKI. Your statement will be included in the record in its entirety.

[The prepared statement follows:]

STATEMENT OF HON. JACK BROOKS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

Mr. Chairman, I thank you for this opportunity to appear today to urge the Subcommittee's favorable consideration of H.R. 5512. This bill is very important to the Moody Foundation in my Congressional District in Galveston, Texas. The Moody Foundation is a tax exempt private Foundation. It has, since 1968, leased office space especially designed for its use from the Moody National Bank in the Moody National Bank Building, a seven story office building in Galveston Texas. The Foundation is currently paying no more than a fair market rental value for its office space. Under Section 4946 of the Internal Revenue Code of 1954, the Moody National Bank is a "disqualified person" with respect to the Foundation because more than 35 percent of its outstanding voting stock is owned by disqualified persons. Under the law, leasing between a private foundation and a disqualified person is considered an action of self-dealing and is prohibited. Such a lease is subject to excise taxes.

Without a change in the law, the Foundation will have to move from the Moody National Bank Building or disqualified persons including the Foundation's managers will incur substantial excise taxes. The cost of a move would be substantial. Of course, the move would also be quite inconvenient to the Foundation in that it would lose its proximity to the bank which performs services important to the operation of the Foundation. Moreover, the shortage of office space in Galveston makes it difficult to find other comparable office space. Aside from the costs and inconvenience of such a move, the Foundation trustees believe that the money paid to move and refurbish other offices could be better spent on charitable activities.

H.R. 5512 would amend section 4941(d)(2) of the Internal Revenue Code to permit a private foundation to lease office space from a disqualified person in a building in which there are tenants who are not disqualified persons if the lease terms are no less favorable to the foundation than they would be in an arms-length transaction. I might point out that under this bill, foundations which were originally grandfathered would continnue to be grandfathered indefinitely, but only where there were tenants in a building where there were not disqualified persons. This provision would minimize any potential enforcement problems by the Internal Revenue Service in that their arms-length standard would be readily available to test the rental price being paid by the foundation. Might add that I have been advised by the Internal Revenue Service that they do not oppose H.R. 5512.

Mr. Chairman, I appreciate your kind consideration and hope that you and your Subcommittee Members will pass our distinguished colleague, Mr. Jake Pickle's bill, H.R. 5512 promptly.

Thank you.

Mr. BROOKS. I would just add to what my distinguished colleague, Mr. Pickle, has said—a couple of items. We feel that the cost of moving, going through that process, would be better spent in public donations which this foundation would otherwise use the money for.

I might add, I have been advised that the Internal Revenue Service does not oppose 5512. The other comments Mr. Pickle made are accurate, it is a very modest procedure to protect a foundation which does a tremendous amount of good. They have their income, which is roughly $8 to $10 million, and they give it all away. They are not "ratholing" it, and I think they are following the law and are very fine public citizens.

I have with me two witnesses, Mike Wylie, who is counsel for the foundation. He has a statement which I would ask unanimous consent to put in the record.

Mr. ROSTENKOWSKI. Without objection, the statement in its entirety will be included.

[The statement of J. Michael Wylie follows:]

STATEMENT OF J. MICHAEL WYLIE, COUNSEL, MOODY FOUNDATION, GALVESTON, TEX.

My name is J. Michael Wylie, 2400 One Dallas Centre, Dallas, Texas 75201. I am an attorney and I serve as tax counsel to The Moody Foundation, a private foundation in Galveston, Texas. My appearance today is in my capacity as tax counsel to the Foundation.

The Moody Foundation ("the Foundation") is a tax-exempt private foundation under section 509(a) of the Internal Revenue Code of 1954, as amended (the "Code"). Under the Trust Indenture creating the Foundation, the Foundation must maintain its domicile in Galveston, Texas. The Foundation has since 1968 leased office space (currently 4,516 square feet), especially designed for its use, from the Moody National Bank (the "Bank") in the Moody National Bank Building, a seven-story office building in Galveston, Texas, in which there are ten other commercial tenants besides the Foundation and the Bank. Under section 4946 of the Code, the Moody National Bank is a "disqualified person" with respect to the Foundation because more than 35 percent of its outstanding voting stock is owned by disqualified persons.

Under section 4941(d)(1)(A) of the Code, leasing between a private foundation and a disqualified person is considered an act of self-dealing and is prohibited. Such a lease is subject to the excise taxes imposed under section 4941. However, a transitional rule found at § 101(1)(2)(C) of Public Law 91–172 (contained in Regulation 53.4941(d)–4(c)) allowed foundations to continue leasing until December 31, 1979, from disqualified persons if such leasing was pursuant to a lease (or renewals of a lease) which was in effect on October 9, 1969, and if the lease was as favorable to the foundation as an arm's-length lease with an unrelated party. The lease between the Bank and the Foundation and all renewals of that lease came within the transitional rule; and the Foundation continued to lease from the Bank pursuant to that rule until December 31, 1979.

Since the December 31, 1979 expiration of the transitional period, the Foundation has been leasing from the Bank pursuant to a lease renewal under which the Foundation pays no rent unless and until legislation is passed which will allow the Foundation to continue to lease from the Bank on an arm's-length basis. Under Regulation § 53.4941(d)–2(b)(2), leasing without charge is not an act of self-dealing. This provision for the payment of no rent is, however, a temporary measure and cannot be continued indefinitely by the Bank.

Thus, without a change in the law, the Foundation will have to move from the Moody National Bank Building or disqualified persons, including the Foundation's managers, will incur substantial excise taxes under section 4941 of the Code. There are certain reasons why such a move would work an undue hardship on the Foundation. There is no available comparable space in a comparable building in Galveston to which the Foundation could move. Such space has not been available in the past twelve months, nor is such space expected to become available in the near future. This inability to find appropriate space is due to the very limited supply in Galveston, Texas, of office space of the type and amount required by the Foundation. Appended to this statement are copies of letters from three qualified Galveston realtors attesting to the absence of comparable office space. The cost of moving the Foundation's offices is estimated to be substantial. In addition, such a move would also be very inconvenient for the Foundation in that it would lose its proximity to the Bank which performs services which are important to the operation of the Foundation, such as transfer of funds, safekeeping of securities and checking accounts. Aside from the absence of comparable office space to move to, the cost of moving and the inconvenience of such a move, the Foundation trustees believe that the money paid to move and refurbish other offices or to build its own building in which to office could be better spent funding charitable activities.

In its report and recommendations delivered to Congress on December 6, 1975, the Commission on Private Philanthropy and Public Needs, otherwise known as the "Filer Commission," recommended the elimination of the prohibitions in section 4941 on self-dealing and the substitution of defined arm's-length standards. The Commssion's Staff specifically recommended that leasing between a disqualified person and a private foundation be governed by an arms's-length standard similar to the standard under section 4975. Section 4975(d)(2) of the Code, passed as part of ERISA in 1974, allows a qualified employee plan to lease office space from a disqualified person if no more than reasonable compensation is paid therefor. Thus, a tax-exempt employee plan has since 1974 been permitted to lease office space for reasonable compensation from a disqualified person, but a private foundation is not allowed to do so at the present time.

Accordingly, through H.R. 5512 the Foundation seeks to amend section 4941 (d)(2) of the Code to permit a private foundation to lease office space from a disqualified person in a building in which there are tenants who are not disqualified persons if the lease terms are no less favorable to the foundation than they would be in an arm's-length transaction. Under the proposed amendment, foundations which were originally leasing in October, 1969, from a disqualified person and who were grandfathered under § 101(1)(2)(C) would continue to be grandfathered indefinitely, but only where there were tenants in the building who are not disqualified persons. This latter provision would minimize any potential enforcement problems by the Internal Revenue Service in that an arm's-length standard would be readily available to test the amount of rent being paid by the Foundation.

Section 202 of S. 2297 is substantially identical to H.R. 5512 and has been reported favorably by the Senate Finance Committee without opposition from the Treasury Department or any members of the Committee. The bill is to be voted on by the Senate at an appropriate time.

GALVESTON, TEX., *September 13, 1979.*

Mr. ROBERT E. BAKER,
Executive Administrator, The Moody Foundation,
Galveston, Tex.

DEAR MR. BAKER: You have requested that I make a search to determine the availability in Galveston of approximately 5,000 square feet of exclusive rental office space similar or equal in quality and utility to that space, approximately 4,500 square feet, presently occupied by The Moody Foundation in the Moody National Bank building, Galveston, Texas. You have also requested that I determine, as a professional Realtor, if there would be any difficulty in finding occupancy or tenants for rental of the presently occupied Foundation space in the Moody National Bank building, should it be vacant.

As of September 13, 1979, I have made a thorough search of the small Galveston market in office space and find only one comparable quality building with comparable prestige offices, utility, and fitting the need to compare with that presently occupied by The Moody Foundation. The First Hutchings-Sealy National Bank building, also downtown, is the comparable and enjoys 100 percent occupancy and any openings or availability would be on a catch as catch can basis; however, any vacancy there of 5,000 square feet would be remote: other office space does exist in much smaller size, much less prestigious, and does not fit the need, and is away from the central downtown area. I have examined the present space occupied by The Moody Foundation in the Moody National Bank building and find that such space enjoys at least 4 portals or points of access to necessary hallways which could, if necessay, lend itself to partition of a larger space into several smaller spaces for smaller space requirements of tenants. As mentioned, there is a shortage of larger space rentals, therefore, I would anticipate no problem in finding tenancy for The Moody Foundation area. In fact, my survey and appraisal of the entire Moody National Bank building shows only recent vacancy of 591 square feet and such vacancy occurred September 1, 1979, due to a business failure (Promotional Advertising, Inc.). The Moody National Bank building should shortly again attain 100 percent net rentable occupancy.

I certify that I have no present or contemplated interest in the subject herein, no bias toward the subject or any principal involved and that my professional fee for the feasibility inquiry accomplished is in no way reflective of the results determined.

Our professional qualifications are attached. Please advise of any clarification needed.

Sincerely,

ROSS J. NOVELLI,
G.R.I. Graduate Realtors Institute,
C.A.—S. Certified Appraiser—Senior.

JACK EVANS REALTY AGENCY,
Galveston, Tex., September 21, 1979.

Mr. ROBERT E. BAKER,
Executive Director, The Moody Foundation,
Galveston, Tex.

DEAR MR. BAKER: In response to your inquiry as to the availability of office space in the between four to five thousand square foot size range in the downtown or near downtown area, this is to advise that I am not aware of any space meeting this criteria that is presently available or apt to be available in the near future.

It is my considered opinion that there is a critical shortage of good quality office space in Galveston, and there is seemingly nothing being planned to increase the supply.

Very truly yours,

JACK EVANS.

GALVESTON, TEX., *September 21, 1979.*

Mr. ROBERT E. BAKER,
Executive Director, The Moody Foundation,
Galveston, Tex.

DEAR MR. BAKER: In reply to your recent inquiry concerning the availability of office space similar to that presently occupied by The Moody Foundation at the above location, I have given some thought as to what buildings in this city would have comparable space.

Only the First Hutchings-Sealy National Bank Building, The Sealy-Smith Professional Building, and the building occupied by the Foundation are truly comparable. The United States National Bank Building would be of lesser quality. Such other office space as exists in this city is far below the quality of your present quarters.

In any case, investigation discloses there is no office space containing from 4,500 to 5,000 square feet in any of the comparable buildings that is presently available.

Should further information be desired, please contact me.

Very truly yours,

T. A. WATERMAN,
MAI, SRPA, CRE.

Mr. BROOKS. And the distinguished Mr. Baker, Robert Baker, who runs the foundation. If you have any questions, we would be delighted to try and answer them. I want to thank you very much for scheduling this bill, for considering it, for going to the trouble of trying to evaluate the necessity of this legislation.

Mr. ROSTENKOWSKI Thank you. Mr. Pickle, does that conclude your testimony?

Mr. PICKLE. Yes, that concludes it.

Mr. ROSTENKOWSKI. I just have one question. I realize the problem in today's market with respect to rent. But this foundation has it not been on notice since 1969 to try to find adequate space, as opposed to leasing the bank's facilities?

Mr. BROOKS. I think they have been on notice, and they have been trying to avoid it because the facts are very simple. They own an interest in a bank which they had to dispose of, or are in the process of disposing of. But right now they still own it. They have offices in that bank. It is downtown where they needed that service.

Now, they could build another building somewhere in town at considerable expense, or they could buy other space. There is a shortage of space on that island, but they could manage to do that. But, it would cost an awful lot of money. It would come right out of the foundation and is sort of really counterproductive of what we want to get out of a foundation.

So, from the standpoint of just good business they ought to stay where they have a good office space, pay reasonable rent for it. All their records are public, there is no hanky-panky in it. That is the basic reason, Mr. Chairman.

Mr. ROSTENKOWSKI. Are there any questions?

Mr. GUARINI. Just one simple question.

Mr. ROSTENKOWSKI. Mr. Guarini?

Mr. GUARINI. Would this affect only the Moody Foundation, Jack, or would it affect other foundations as well that we have not heard from?

Mr. BROOKS. If you met the test, I think it would be a general law, but the provisions require that the business be in that community, have other tenants in the building, and that the rent be not less than that paid by others.

Mr. GUARINI. So, you do not know how many it might inadvertently apply to at this time?

Mr. BROOKS. No, but I think very, very few. I do not know of any. There could conceivably be one.

Mr. GUARINI. Now, this would not cost the Government any money, it is just a matter of their staying where they are and not looking for new facilities; is that right?

Mr. BROOKS. That is my understanding.

Mr. GUARINI. So, therefore, the taxpayer loses nothing by reason of this bill going through.

Mr. BROOKS. That is my understanding.

Mr. ROSTENKOWSKI. If there are no further questions, I want to thank you gentlemen for joining us this morning. Congressman Brooks, Congressman Pickle, thank you very much.

Mr. Koplan? Welcome to the committee, Mr. Koplan. If you would identify yourself for the record and proceed with your testimony, the committee is ready to receive it.

STATEMENT OF STEPHEN KOPLAN, LEGISLATIVE REPRESENTATIVE, AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS; ACCOMPANIED BY ARNOLD CANTOR, ASSISTANT DIRECTOR, DEPARTMENT OF ECONOMIC RESEARCH

Mr. KOPLAN. Mr. Chairman, my name is Stephen Koplan and I am a legislative representative for the AFL-CIO. The AFL-CIO is in opposition to H.R. 7553 which embodies the administration's proposal to eliminate the 30-percent withholding tax on interest paid to nonresident aliens and foreign corporations on U.S. source income.

We opposed a similar proposal in 1975, which was appropriately rejected in the House by a vote of 301 to 119. In July 1976, the Senate also voted by a wide margin against repeal.

Today's economic conditions demand that this latest attempt to repeal be similarly rejected. In this regard, we are watchful of an identical repeal provision which was tacked on to a routine House-passed duty suspension bill, H.R. 2297, by the Senate Finance Committee last December, without the benefit of hearings.

Present law provides in general that interest, dividends, and other similar types of income of a nonresident alien or a foreign corporation are subject to a 30-percent tax on gross amount paid if such income or gains are not effectively connected with the conduct of a trade or business within the United States. This tax is generally collected through withholding by the entity making the interest or dividend payment to the foreign recipient of the income. For this reason the tax is commonly referred to as a withholding tax.

Those advocating the repeal of the interest income portion of these provisions justify their position as a means to attract foreign capital, with a resultant benefit to the U.S. economy and the generation of jobs. In our view there is absolutely no reason to accept a blanket assumption that foreign investment in the United States creates jobs for Americans or is necessarily beneficial to the American economy. In fact, the type of investment that would be encouraged through eliminating the 30-percent withholding tax would in the main be speculative "hot" money that can and does move quickly and freely from country to country. Speculative capital that comes into the United States temporarily as a result of tax preferences is not the kind of capital that creates jobs, increased productivity, or contributes to the health of the economy. To the contrary, such flows merely add to instability and uncertainty.

In addition, most industrialized foreign countries allow their citizens to offset, through credits or other means, taxes paid to other countries against those levied in their home country. Thus, in these circumstances, repealing the U.S. tax merely amounts to a transfer of funds from the U.S. Treasury to the treasury of a foreign government.

Repealing the present 30-percent withholding tax on interest income would add a new tax preference, costing the U.S. Treasury and American taxpayers $30 million or more annually. With the preoccupation of Congress to cut spending and balance the budget, we question which social programs are destined to pick up the $30 million price tag for this foreign subsidy. We see no reason why foreign investors who enjoy the security, protection, and profit from investing in the United States should be exempted from making some contribution to this Nation's taxes. American investors are required to pay income taxes on their interest income to the U.S. Government when earned in the United States. And, except where waived by bilateral treaties, they also pay taxes to foreign governments on income earned overseas.

It is ironic that while the administration is proposing on the one hand repeal of the 30-percent withholding tax on interest paid to foreign investors, the administration at the same time is proposing a long overdue measure to apply withholding of 15 percent to existing taxes on interest and dividends income of American citizens. It is impossible to reconcile a policy of tight credit on U.S. citizens struggling to purchase a home or an automobile when at the same time we encourage Wall Street to float U.S. corporate bonds in foreign markets, using a tax break not available to American citizens. We note, for example, that in 1975 the Nation's large brokerage houses helped lead the attempt to repeal this provision.

As Americans we have long criticized those so-called tax-haven countries which, in an effort to lure capital, grant special tax exemptions. The AFL-CIO does not feel that the United States should follow the example set by these countries. In fact, in 1975 as part of the Tax Reduction Act the Congress eliminated some of the tax avoidance opportunities enjoyed by U.S. multinational companies that operate in the "tax-haven countries."

The AFL-CIO urges rejection of H.R. 7553 which would eliminate the 30-percent withholding tax on U.S. source income paid to foreign investors.

In addition, Mr. Chairman, we understand several miscellaneous bills also are being considered at this time. We did not refer to these measures in our prepared statement, but would like to briefly, for the record, present our views on three of these measures.

We are opposed to H.R. 4640, which would exempt private foundations with holdings of more than 50 percent of an independent local newspaper from the tax imposed upon excess business holdings. Under this bill there would be no limitation on the percentage interest that a foundation may own.

We see no reason why a private foundation in the newspaper business should be exempt from the excess business holding provision of the 1969 Tax Reform Act.

We are also opposed to H.R. 5847, a measure which would permit tax exempt industrial development bonds to be used to refinance existing conventionally financed docks and wharves located in Tampa, Fla. The principal beneficiary of the bill according to the Joint Committee on Taxation would be the Agrico Chemical Co.

Present law generally prohibits the use of tax exempt industrial bonds as a refinancing device. It is our understanding that the Congress in permitting tax exempt industrial development bonds intended their use to encourage new facilities essential to economic development. Tax exempt refinancing of existing—conventionally financed—structures does not meet such objectives.

H.R. 4175 would allow as a deduction, charitable donations to fraternal organizations for construction or maintenance of buildings housing those organizations. Under existing law, contributions or gifts to such organizations are deductible only to the extent that they are used exclusively for religious, charitable, scientific or similar purposes. Extending permissible deductions to include acquisition, building or maintaining a structure goes far beyond the purposes of the charitable contribution deduction and would amount to an inappropriate, uncalled for tax subsidy for such organizations.

Mr. Chairman, all these measures would reduce Federal revenues, increase budgetary strains and add to tax injustice. The AFL-CIO recommends they be rejected.

Mr. ROSTENKOWSKI. Thank you, Mr. Koplan. Are there any questions?

Mr. KOPLAN. Mr. Chairman, I meant to introduce Arnold Cantor, the assistant director of our department of economic research, who is accompanying me this morning.

Mr. ROSTENKOWSKI. Thank you. Are there any questions of the witness?

Mr. GUARINI. I want to compliment you, Mr. Koplan, on the insights in your statement because it is very interesting to hear somebody speak up for Treasury, especially when Treasury does not.

I am interested in your reference to H.R. 5847, where you are against tax-free bonds for harbor improvements. Does that mean that you would be against tax-free bonds for harbor improvements for the port authority, for instance, in New York and other areas for which we do recognize tax-free bonds?

Mr. Koplan. No, sir. On that issue I would really like to echo some of the points that Assistant Secretary Lubick made in that I think two distinctions have to be made here. One is whether it is a government or quasi-government facility. Second, I think perhaps in this case the more essential distinction is the question of refinancing. So, we would not object to what you are discussing. We feel that this goes far beyond the intent of tax-exempt industrial development.

Mr. Guarini. Thank you very much.

Mr. Rostenkowski. If there are no further questions, thank you very much, Mr. Koplan. Oh, I am sorry, Mr. Holland.

Mr. Holland. Thank you, Mr. Chairman.

Mr. Koplan, it appears to me that 7553 would eliminate withholding and certification requirements for interest payments to foreign addresses, and therefore create opportunities for U.S. citizens to evade taxes through offshore holdings. Would you comment on that?

Mr. Koplan. Yes, Mr. Holland. That assertion was included as part of Mr. Lubick's testimony, but my reading of H.R. 7553 leads me to an opposite conclusion.

Section 898 of H.R. 7553 specifically provides that whenever the Secretary determines that the exchange of information between the United States and a foreign country is inadequate to determine the beneficial recipients of interest payments from sources within the United States, and that such information is necessary in order to prevent evasion of taxes, the exemption from tax shall not apply to payments addressed to, or for the account of persons within such foreign country.

Now, my reading of that section is that it does provide the Secretary with a workable compliance mechanism to prevent evasion. Since the amount of withholding under present law can vary greatly, depending on which particular foreign country is involved, I would recommend that language similar to that contained in section 398 be added to present law, even if the 30-percent withholding tax is retained.

Mr. Holland. And finally, Mr. Lubick made a point that many of our treaties now call for reciprocal elimination or reduction of the 30-percent statutory tax on interest, which results now in virtual elimination of the existing U.S. withholding tax on foreign entities. Do you agree with that?

Mr. Koplan. No, I do not. The amount that we collect now is significant. According to the estimates prepared by the staff of the Joint Committee on Taxation elimination of the 30-percent tax, even taking into account present exemptions, will reduce budget receipts by $36 million in fiscal year 1981; $39 million in 1982; $43 million in 1983; $47 million in 1984, and $52 million in 1985 for a total of $165 million.

Two other points, though, should be made here. First, the key word in those treaties is the word "reciprocal." Unilateral reduction or elimination by the United States is simply a subsidy to a foreign country. Why should we be gratuitously taking such a step?

Second, if we add to present law a requirement that provides for identification of the true beneficial owner similar to that contained in section 898 of H.R. 7553, I think we will see a rapid decline in treaty shopping and a dramatic increase in the amount of revenue we collect.

Mr. HOLLAND. Thank you, Mr. Koplan; thank you, Mr. Chairman.

Mr. ROSTENKOWSKI. Thank you, Mr. Koplan, thank you very much.

Mr. Gibbons? Welcome, Mr. Gibbons, to the committee. It is always a pleasure to have you in our midst. Certainly, no Member of Congress is more active on the Ways and Means Committee than are you. We always look for your counsel in these hearings.

STATEMENT OF HON. SAM M. GIBBONS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF FLORIDA

Mr. GIBBONS. You are very generous, Mr. Chairman, and I appreciate you having this hearing; and second, allowing me to come out of order.

I would ask the people from the Tampa Port Authority to come forward and join me at the table here, if they will.

Mr. Chairman, I know you are all sick and tired of hearing me brag about that Port of Tampa down there, but let me say for the record here that the Port of Tampa is the third-largest export port in tonnage in the United States. It is a big national asset. It puts money in the Treasury down here on Pennsylvania Avenue, a lot of money. Nationwide it is the 27th largest port in the United States as far as tonnage is concerned.

I will not remind you that the bridge fell down a couple of weeks ago when one of the large tankers hit it, you heard that discussed to a great extent.

Seated to my right is Mr. Lee. Mr. Lee is the executive director of this large port. It is a public agency. It was organized by the State of Florida in the 1940's and it owns and operates most of the facilities in the Port of Tampa.

Sitting next to him is the general counsel for the port authority, a public agency, Mr. Terrell Sessums. Mr. Sessums is a very distinguished lawyer in Florida and a former speaker of the house of representatives of the State of Florida.

Seated next to him is Mr. Fox, who represents Agrico Chemical Corp., and who is trying to assist us in unwinding this very complex problem.

You have heard Mr. Lubick testify. The Treasury kind of skids all over the map about these proposed bonds. One time they are for them; another time they are against them; and another time they are split in-between. Frankly, I do not want to hold up the progress of the Port of Tampa. The facilities that are involved here will be owned and operated by the Port of Tampa Authority which, as I say, is a public agency—not a private agency, and they will be there for the public's use, not for any particular private use. They will be operated as other terminals are around the United States.

So, I do not know why all of the "hoopla" because of this little old bill. Frankly, you know, I have never been classified as one of those who is in favor of using industrial development bonds for private purposes, but this is a public purpose, as I see it. I think these gentlemen can explain it much better, in greater detail, and answer any questions that I can.

Let me say, I know how busy this committee is and I want to thank you, Mr. Rostenkowski, for the generosity of just allowing me to be heard here.

Mr. ROSTENKOWSKI. Thank you for joining us, Mr. Gibbons.

Mr. GIBBONS. I will go over now and help Mr. Vanik get a quorum.

Mr. ROSTENKOWSKI. Well, leave a few of my fellows here so I can have a quorum, too.

Mr. Lee, if you would identify yourself, please. You may proceed with your testimony.

STATEMENTS OF EMMETT C. LEE, DIRECTOR, AND T. TERRELL SESSUMS, GENERAL COUNSEL, TAMPA PORT AUTHORITY

Mr. LEE. Mr. Chairman, members of the committee, I am Emmett C. Lee, the executive director of the Tampa Port Authority. As indicated by Congressman Gibbons, with me is Mr. T. Terrell Sessums, our general counsel, and Mr. Larry Fox.

We are here to testify with regard to H.R. 5847, introduced by Mr. Gibbons, with cosponsors Mr. Bafalis, Mr. Young, Mr. Ireland, and Mr. Vander Jagt, whose name, I believe was omitted inadvertently from the pamphlet concerning the bill.

The Port of Tampa today ranks as the seventh largest port in the United States and the third largest in terms of export tonnage. This ranking is in large measure due to the shipment of phosphatic materials—that is to say phosphate rock and fertilizers—through the port. The phosphate industry, I think it is important to recognize, is the third largest industry in the State of Florida, with 75 percent of the U.S. production of phosphate coming from the Bone Valley area, which is near the Port of Tampa.

Accordingly, phosphate accounts for more than half of all the cargo and about 94 percent of all outbound tonnage through the port.

The Tampa Port Authority endorses H.R. 5847 and urges its expeditious passage by the Congress. The bill will enable the authority to purchase the Agrico Chemical Co.'s existing Big Bend phosphate terminal and to then undertake a substantial expansion of the terminal. This expansion in capacity is desperately needed by the port to solve the serious congestion now existing there, and the consequent demurrage problem that now exists.

On any given day there may be from 8 to 10 bulk carriers riding at anchor off Mullet Key awaiting their turn at the phosphate docks. The demurrage cost on these vessels is a direct cost of the industry and affects its ability to compete on the world market.

This purchase would also give the authority greater control over the facilities, which we feel will be directly in the public interest.

H.R. 5847 amends the law to permit the issuance of tax-exempt revenue bonds for the acquisition of existing port facilities, even though the prior owner remains a substantial user. This amendment will permit the Tampa Port Authority to expand the port on an economic basis and make it more efficient.

The proposed transaction benefits the port of Tampa by giving it title to the existing Agrico facilities and approximately 100 acres of adjacent deep-water waterfront property to be used for future development.

In addition to amortizing bonds issued by the authority to acquire the existing facilities, rental and wharfage payments will also increase the authority's annual revenues by approximately $500,000.

These revenues will amortize $3 million of additional revenue bonds issued to acquire the 100 acres of additional waterfront property, suitable for future expansion. The net revenues remaining can be used for other authority purposes. This, I would say, is extremely important to us because the Port of Tampa and the port authority have traditionally depended upon direct revenues and not on tax money to support its operational expenses and its capital improvements.

The acquisition of Big Bend and its renovation to double its shipping capacity and enable it to ship products it cannot presently ship, plus the addition of a new substantial user, will permit the authority to improve the efficiency of the port and reduce the demurrage problem previously mentioned.

The authority will also be in a position to assure optimum future development of this vital shipping center.

We detailed in our written statement both the State of Florida and the Federal Treasuries would immediately derive increased revenues from this transaction. The State would receive increased revenues from sales taxes on the expansion and improvement of the facility, and from severance taxes on the higher levels of phosphate rock production that would be stimulated by these improvements in the port. The Federal Government would receive increased tax revenues due to the reduction in demurrage deductions and increased sales of phosphates and derivative products.

It should be clear to everyone that we are here today because the Treasury regulations are a barrier to the port authority's commitment to Congress to acquire and improve the port facilities in Tampa in return for the Federal commitment to deepen the harbor. When we made that commitment in 1970 to the Federal Government, both the code and the regulations would have permitted the proposed transaction we are considering today. While the code has not been amended in this regard, Treasury changed the regulation in 1972. There is testimony before the Senate Finance Committee on an identical bill, S. 2548, where the Treasury stated that the policy underlying its regulation should be, "Re-examined and clarified."

The Treasury is obviously concerned with the broad policy questions raised by the existing regulations and whether they should be revised in several respects. Such a study, however, would take time and should not be a reason to prevent this proposed transaction from going forward in accordance with the proposed legislation.

Moreover, there are many policy reasons why tax-exempt financing should be permitted in this case. The acquired facility will, in effect, be a new facility in terms of the addition of at least one new substantial user, more than doubling the shipping capacity of the terminal, and the addition of a new product at the terminal which cannot be shipped now, and which will then account for more than 50 percent of the shipments from the terminal. It is not a refinancing as characterized by the Treasury.

In addition, the cost of this renovation, some $23 million, will exceed 50 percent of the acquisition cost, $43 million, of the existing facility.

Thus, using the rationale expressed by Treasury to the Senate Finance Committee, this is a meritorious transaction.

We thank you, sir, for this opportunity to testify and we urge your favorable consideration of the bill.

Mr. Rostenkowski. Thank you, Mr. Lee.

Mr. Sessums. Mr. Chairman and members of the committee, I would make a very brief reply to three points raised by Mr. Lubick of the Treasury.

It had been suggested at the outset that the Tampa Port Authority might only be a quasi-governmental agency. Congressman Gibbons pointed out that the Tampa Port Authority is a governmental agency, established by Florida law to manage and develop the Port of Tampa. Its members are appointed by the Governor of Florida, confirmed by the Florida Senate, and are public officials in a political subdivision of the State of Florida.

The second point, Mr. Chairman, that I would make is that it has been represented that the principal beneficiary of the bill would be the Agrico Chemical Co. Obviously, the Agrico Chemical Co. will be a beneficiary of the bill, otherwise they would probably not be cooperating with our public port authority in an attempt to acquire and expand their terminal facility.

The reason we want to acquire it is the reason that we believe makes this the public and the port of Tampa the principal beneficiary of this project, not Agrico Chemical Co. per se. Because, as Mr. Lee pointed out, by acquiring this terminal and taking title from Agrico, and by expanding it, we will be able to break a serious bottleneck that exists in our port in the movement of phosphate in the export market. Breaking this bottleneck will benefit not just Agrico, but will benefit primarily all the other shippers and users of our port and serve a fairly competitive world phosphate market much better.

So, we believe that our port as a whole will be principal beneficiary of this bill and not just Agrico. Agrico, though, has said, "We cannot do this if we are going to be locked out or blocked from moving our own cargo through. We will do this, but one of the conditions is, we have to be able to continue to move our own rock through this," which we think is a reasonable precondition of the sale to our authority.

But we want to substantially enlarge this facility so that not just Agrico's product but the product of many other phosphate companies can move through this port and we can alleviate the demurrage problem. Incidentally, the demurrage cost which ranged between $7 and $10 million last year are—I hope Treasury would note—is a tax deductible loss. We would hope by eliminating the demurrage problem to have a favorable impact upon the U.S. Treasury in terms of actual tax collections.

The third point I want to make is this—and I think Mr. Lubick may not have completely understood the facts of the transaction—we are not interested in simply helping Agrico refinance. We want to acquire and put this facility in public ownership so that it can be enlarged to serve more than just Agrico. But it is going to be a substantially large facility, otherwise there would be little point in our port authority making this acquisition. We ought to make approximately $20 to $23 million of improvements, an amount over 50 percent of the acquisition price, determined almost a year ago by our appraiser, not Agrico's.

So, we believe the project will be accompanied by a substantial enlargement, by a change, so that instead of simply moving wet phosphate rock it will also move dry phosphate rock and a number of other products.

For those reasons, Mr. Chairman, we believe that the public is the primary beneficiary of this project.

[The prepared statement follows:]

STATEMENT OF EMMETT C. LEE, PORT DIRECTOR, AND T. TERRELL SESSUMS, GENERAL COUNSEL, TAMPA PORT AUTHORITY

INTRODUCTION

The Port of Tampa today ranks as the 7th largest port in the United States. This ranking is in large measure due to the shipment of phosphatic materials—phosphate rock and fertilizers—through the Port. Phosphates account for more than half of all cargo and about 94% of all outbound tonnage through the Port.

The Tampa Port Authority endorses H.R. 5847 and urges its expeditious passage by the Congress. This bill will enable the Authority to purchase Agrico Chemical Company's existing Big Bend Phosphate Terminal, and to then undertake a substantial expansion of the Terminal. This purchase is desperately needed by the Port to solve the serious demurrage problem that now exists and to acquire greater, direct control over port facilities.[1]

H.R. 5847

H.R. 5847 amends the law to permit the issuance of tax exempt revenue bonds for the acquisition of existing port facilities even though the prior owner remains a substantial user. This amendment will permit the Tampa Port Authority to expand the Port on an economic basis and make it more efficient. In particular, it allows the Authority to purchase the existing Big Bend Phosphate Terminal at East Bay Tampa owned by Agrico Chemical Company, and to undertake an expansion of those facilities leasing them back to a joint venture that includes Agrico and at least one new substantial user.

BENEFITS TO THE PORT OF TAMPA

The proposed transaction benefits the Port of Tampa by giving it title to the existing Agrico facilities and approximately 100 acres of adjacent waterfront property. In addition to amortizing bonds issued by the Authority to acquire the existing facilities, rental and wharfage payments will also increase the Authority's annual revenues by approximately $500,000. These revenues will amortize $3 million of additional revenue bonds issued to acquire about 100 acres of adjacent waterfront property suitable for future expansion, with net revenues remaining that can be used by the Authority for other purposes. The acquisition of Big Bend and its renovation to double its shipping capacity and enable it to ship products it cannot presently ship plus the addition of a new substantial user will permit the Authority to improve the efficiency of the Port and reduce the demurrage problem that is seriously impeding ship traffic today. The Authority would also be in a position to assure optimum future development of this vital shipping center.

As we detailed in the attached statement both the State of Florida and the Federal treasuries would immediately derive increased revenues from this transaction. The State would receive increased revenues from sales taxes on the expansion and improvement of the facility and from severance taxes on the higher levels of phosphate rock production that would be stimulated by these improvements in the Port. The Federal Government would receive increased tax revenues due to the reduction in demurrage deductions and increased sales of phosphates and derivative products.

In addition, it should be noted that the immediate revenue impact on the U.S. Treasury is positive, as Agrico would be subject to a $1.6 million investment tax credit recapture and a $1.1 million capital gains tax on the sale of the facility. These revenue gains more than offset any initial Federal revenue loss from the issuance of tax exempt bonds.

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[1] A copy of the Port Authority's statement filed with the Senate Finance Subcommittee on Taxation & Debt Management Generally on S. 2548 (identical to H.R. 5847) is attached as a part of the testimony before this Committee.

Statement of Ted DeLaVergne, Jr., Chairman, and T. Terrell Sessums, General Counsel, Tampa Port Authority

INTRODUCTION

The Tampa Port Authority is attempting to fulfill its obligations to the U.S. Congress to expand and improve the Tampa Port. As the Port continues to expand, the majority of new acquisitions will be property (land and facilities) already owned and being used by taxpayers who would want to continue to be in business after the Authority purchases their property and improves it. Moreover, the economic viability of the Port is based upon the expertise and rental payments that will be provided by such taxpayers.

The Authority's mandate is severely restricted by a provision in Treasury Reg. § 1.103–8(a)(5), which provides that the tax incentive contained in Section 103(b)(4) is not allowed if a lessee of the property to be acquired by the Authority is a prior substantial user. This rule will hinder and may eliminate the Port's future growth because it may not acquire existing property and lease it back to the prior owner. S. 2548 makes it clear that the Authority's activities qualify for tax exempt financing under Section 103(b)(4)(D).

SUMMARY

1. The Tampa Port Authority believes that its statutory mandate, its method of operation, and the legislative history behind Section 103(b)(4)(D) supports the conclusion that the Code should be clarified as provided in S. 2548 to allow the Port Authority to issue its tax exempt bonds whether or not a previous owner is a co-tenant.

2. Without the passage of S. 2548, the Authority will be severely hindered in providing additional port facilities which is the antithesis of the intent of the State of Florida and the United States Congress.

3. In addition to being extremely important to the Port's future and the community's development, passage will have an immensely positive revenue impact upon the Port, the State of Florida and the Federal government. Further, passage will allow the Authority to acquire existing Port facilities and manage them to assure a more efficient port through the elimination of the demurrage problem, at present, a serious hindrance to the competitiveness of U.S. products in the world phosphate market.

BACKGROUND

Statutory Rules

In general, industrial development bonds, as defined in Section 103(b)(2), do not bear tax exempt interest. However, if the proceeds of such a bond are used for certain designated projects,[1] called exempt facilities in Section 103(b)(4), it will nevertheless be treated as a state or local government's obligation and hence bear tax exempt interest.

1972 REGULATORY LIMITATION

No Retroactive Financing

Under Treasury Reg. § 1.103–8(a)(5) the statutory incentive is not allowed even for exempt facilities if a lessee of the property to be acquired is a prior substantial user.[2]

Basis of IRS Position

The foregoing rules, adopted in 1972, bar refinancing, i.e., prevent a taxpayer from refinancing an existing facility with tax exempt obligations. The apparent justification is that the exempt activity exception is to be enjoyed only where the taxpayer can show that the tax incentive "induced" or spurred the construction or acquisition for use by the taxpayer. Obtaining local governmental support (as evidenced by a bond resolution or other similar official action) prior to acquisition or construction indicates reliance upon the statutory benefit.

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[1] Residential real property, sports facilities, convention or trade show facilities, certain public utilities, and air or water pollution control facilities.

[2] Specifically the Regulation requires one, a bond resolution or "some other similar official action" must precede the commencement of construction or acquisition by a substantial user, and two, the bonds must be issued within one year from the date the facilities are completed and placed in operation.

Another rationale behind Reg. § 1.103–8(a)(5) might be that the proceeds from an issue must be used "to provide" a qualifying facility; and accordingly, if bond proceeds are used to refinance a facility, they are used for a purpose other than "to provide" the facility.

Limitation Inappropriate as Applied to Docks and Wharves, In General

The regulatory modification of the statute is baffling when applied to docks and wharves being acquired by public authorities. This is because the most logical method of developing a major port is for a port authority, a public body, to acquire property and facilities adjacent to that which is already owned by the authority. Such a transaction is, in general, economically viable only by leasing the acquired property back to the original owner for a reasonable period of time. House Report No. 1533[8] supports this conclusion in describing the tax exempt treatment to be afforded obligations issued to acquire docks, wharves and related facilities.

"Subparagraph (D) of new subsection (c)(4) applies in respect of obligations issued to provide * * *, docks, wharves * * * or storage or training facilities directly related to a[n] dock, wharf, * * *. For example, a grain elevator or warehouse which is on or adjoins a dock or wharf and which is directly related to it is an exempt storage facility.".

The Committee Report indicates that so long as the proceeds are used to provide the issuer with a dock or wharf or related facilities on or adjoining a dock or wharf, the bonds bear tax exempt interest even though they are industrial development bonds. The fact that the facilities are used, after acquisition by the authority, by someone who also used the facility prior to the issuance of the bonds is immaterial.

Tampa Port Authority

Assuming that the rationale for Reg. § 1.103–8( )(5) is the "to provide" concept and that this approach may be justified as a general rule, it is not supportable when applied to docks and wharves such as those to be acquired by the Tampa Port Authority, for the following reasons:

1. The proceeds of the Authority's bonds will be used "to provide" the Authority with improved and expanded port facilities (as distinguished from classic industrial development bond transactions in which a non-exempt person takes title to the property at some future time). Thus, when the Tampa Port Authority leases its property, title to the property never reverts to a non-exempt person. It should be noted that this is the only practical method through which the Port can carry out its Florida statutory mandate. Moreover, it allows the Authority to satisfy its representation to the United States Congress that if Federal funds were made available for deepening the Port, the Authority would undertake to expand and improve the harbor facilities. Both the Authority and Congress undertook their respective commitments to the expansion prior to 1972 when it was clear under the Internal Revenue Code and Regulations that the Authority could issue its bonds to acquire existing facilities. We would also note that no amendment to this provision of the Code has been made since the Authority made its commitment to Congress and that this administrative restriction is clearly unjustified in this instance.

2. While the Authority has a statutory power of eminent domain, its exercise is severely limited without a corresponding lease back to an entity that includes a prior user. This is so for two reasons: (a) without the prior user, there is little likelihood that the Port Authority could obtain sufficient guaranteed income to amortize the financing for the acquisition, and (b) without the prior user, the facility would not have sufficient participation to justify acquisition of the facility.

3. Allowing the Authority to acquire and expand a facility which will be used in part by a prior owner and in part by a new substantial user precludes the unnecessary building of duplicative facilities. In other words, if the prior user "taints" the existing facilities, the new substantial user will build duplicative facilities relying on tax-free financing.

4. The Authority uses the proceeds from its bonds to first purchase existing facilities and second to improve them. In other words, the Authority is not "refinancing" facilities for existing owners, but instead is acquiring property. In addition, the Authority fulfills its obligation to the State and Federal governments to improve the harbor facilities.

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[8] 90th Congress, 2d Sess. (1968).

5. The Authority leases the acquired and improved property to a group of
companies which may include the previous owner. It should be clear that the
Authority benefits from the transaction because it will ultimately own title to
the facilities and land on an unencumbered basis. In addition, the prior owner has
not "refinanced" since it no longer owns title to the property and will pay taxes
to the extent of its recapture of investment tax credit and gain on the sale to the
Authority. Moreover, there will be an increase in the use of the port by virtue
of the improvements and attraction of new users to the facility.

Regulatory Limitation Particularly in Contravention of Congressional Intent as Applied to Tampa Port

In 1970, Congress authorized the deepening of Tampa Harbor Channels from
34 to 44 feet. In approving this central harbor project, Congress relied upon the
Corps of Engineers' recommendation that the project was worthy. One of the
Authority's representations to the Corps was that it would expand the port. (See
Exhibit A). One of the principal methods of improving and developing the harbor
is cooperation with private business interests and the issuance of long term indus-
trial revenue bonds.

The Authority is complying with its commitment to Congress to expand the
use of the Port. The key to effecting this commitment is for the Auhority to facili-
tate the investment of private capital in the Port by obtaining land, properly
placed for optimum future development. Private operators are expected to con-
tinue to operate terminals, either owned by the Authority or owned and operated
by private owners. With the passage of time, however, the only land and facilities
available will be those that are already owned and operated by existing businesses.

The application of a regulatory rule to restrict the Port's refinancing of docks
and wharves will preclude the Port from acquiring existing facilities. Simply
stated, the Authority cannot expand and improve the harbor if it is estopped
from using the statutory benefits of Section 103(b) (4) by virtue of the fact that
the prior owner will be a user of the facilities after acquisition by the Port
Authority.

POSITIVE REVENUE IMPACT

The Tampa Port Authority is actively considering the acquisition of Agrico
Chemical Company's existing Big Bend phosphate terminal at East Bay. This
acquisition is desirable because it would eliminate the need for duplicative
facilities at another location and would alleviate the Port's demurrage problem.
In addition, this is a significant opportunity for the Authority to acquire approxi-
maatly 100 acres of unimproved waterfront real estate, which would not other-
wise be available to the Port, for future expansion. This land has particular value
to the Authority because unlike other properties in the harbor area, it is outside
the environmental "non-attainment" area of Tampa itself, which fact facilitates
future expansion projects by the Authority. S. 2548 will allow the Authority to
use tax exempt revenue bonds in the amount of $43 million to acquire the terminal
which will be expanded and leased to a joint venture company which will include
Agrico as a joint venturer.

Under existing Section 103(b), approximately $15 million of bonds can be
issued to provide improvements to the existing facilities for the sole use of Agrico
without regard to the addition of new substantial users. Another $3 million of
bonds can be issued to acquire approximately 100 acres of unimproved land
(adjacent to the Port) for future expansion of the Port. Without this legislation
we do not believe that it is economically viable to attract a new substantial user
to Big Bend. Rather a new substantial user would develop its own new facility
using tax free industrial development bonds. We estimate the cost of such bonds
to be $30 million. Thus $48 million of tax exempt obligations can be issued with-
out passage of S. 2548. Only $18 million of additional tax-exempt industrial de-
velopment bonds will be issued if the amendment is enacted. This conclusion is
illustrated by the following table:

	Millions
Bonds to be issued assuming passage:	
Acquisition of existing Agrico facilities	$43,000,00
Expansion and improvements at Big Bend for Agrico and new substantial users	20,000,00
Land	3,000,00
Total obligations to be issued if passage	66,000,00

Bonds to be issued assuming no passage	Millions
Duplicative facilities to be built by new substantial user	$30,000,000
Improvements solely for Agrico	15,000,000
Land	3,000,000
Total obligations to be issued if no passage	48,000,000
Total obligations to be issued if passage	66,000,000
Total obligations to be issued if no passage	48,000,000
Total additional bonds	18,000,000

The theoretical Federal tax revenue loss from the enactment of this bill would be between $450,000 and $540,000 per year, using Treasury estimates of a revenue loss of between $2.50 and $3.00 per $100 of bonds.

The significant annual economic benefits resulting from the entire transaction to the Port, the State of Florida, and the Federal government, are between $15,520,000 and $24,860,000 with an additional one year extraordinary Federal tax gain of $2.7 million from investment tax credit recapture and capital gains tax.[4]

The following discussion analyzes the benefits that will redound to the Tampa Port Authority, the State of Florida and the Federal Treasury if this amendment to Section 103 of the Code is enacted:

TAMPA PORT AUTHORITY

1. The existing Agrico facilities will be purchased by the Authority at their appraised value of $43 million. They will become a substantial asset of the Authority when unencumbered.

2. The financed improvements will inure to the Authority.

3. There will be an additional, immediate increase in Authority revenue of approximately $500,000 annually from dockage and wharfage charges on the movement of phosphate and related products in and out of the new and improved Big Bend Terminal facility. The lease and wharfage payments to be made by the joint venture company to the Authority will be sufficient to amortize the principal and interest on $3 million of bonds used to acquire approximately 100 acres of unimproved waterfront property which will be used for future Port development. This land obviously will appreciate in value with the passage of time as well as provide the Port with significant capacity to expand. Thus, this portion of the transaction offers the Authority the present value of the land and the future opportunity for subsequent Port development. Residual revenue will be used for continued Port development and will significantly decrease the Authority's dependence on tax funds in order to finance capital improvements.[5]

4. The acquisition will result in a substantial reduction of vessel demurrage costs now estimated at between $7,000,000 and $10,000,000 per year. These current costs reduce the attractiveness of the Port to vessel operators and which, if they remain unabated, will eventually result in diminished traffic at the Port. (Note: Since demurrage costs are tax deductible, their elimination will increase Federal taxable income and thus Federal taxes.)

Summary

The amendment will produce substantial present and future economic benefits to the Port. The Authority will receive an immediate increase in revenues and about 100 acres of property for development. The additional land and facilities will inure to the Authority. Finally, the so-called Federal revenue loss associated with the "extra" tax exempt bonds will be more than off-set by the Authority's increase in revenue and by the elimination of tax deductible demurrage costs.

STATE OF FLORIDA

1. A significant number of jobs will be created in the construction industry by expanding the present facility.

2. The $20 million expansion will generate over $314,000 in additional sales taxes for the State of Florida.

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[4] See Exhibit B for a detailed economic analysis.

[5] Additionally, this cash flow will enhance the Authority's ability to issue its governmental obligations (general revenue bonds) for other Port Authority projects at a more favorable interest rate.

3. If we assume that an additional 2.0 million tons of dry rock and 0.5 million tons of fertilizer will be shipped by virtue of the acquisition and improvement of the existing facility, an additional 2.8 million tons of phosphate rock will be mined. Based upon the present severance tax of approximately $1.50 per ton, the State would receive an additional $4.2 million per year from the increased export of phosphate rock.

Summary

The amendment will cause an immediate and significant increase in State revenues through sales and severance taxes. This increased revenue to the State will be significantly greater per annum than the theoretical revenue loss to the Federal government from the "extra" tax exempt obligations. Finally, the project will spur employment in the construction industry which will benefit the State in terms of human welfare and the Federal government in increased individual income taxes.

UNITED STATES

1. The improved and expanded terminal will be capable of handling eight million tons per annum of phosphate at the outset, and 14 million tons per annum in the future. Studies by the U.S. Department of the Interior's Bureau of Mines indicate that phosphate production will reach nearly 60 million tons by 1990, of which 30 million tons will move out of the Port of Tampa in foreign and domestic commerce. Without this amendment, the U.S. may not be able to reach these levels.

a. By 1990 the value of phosphate products in foreign commerce will amount to $1 billion annually. This will improve the U.S. balance of trade and will insure jobs for thousands in the phosphate and fertilizer industries.

b. The greater cost effectiveness of the expanded Big Bend Terminal and the effect of the expansion on the Tampa terminals as a whole will improve the competitiveness of U.S. phosphate exports, especially phosphate rock, against increasing competition from Morocco in Europe and other markets.

2. The stimulus to phosphate shipments occurring as previously described, will improve corporate profits and therefore corporate taxes. Our sources indicate that the increase in annual export revenues would be approximately $175 million. In other words, but for this project, the $175 million may not be available for foreign commerce or be subject to Federal income taxes.

3. We have been advised that the transaction would result in substantial federal income taxes being collected from Agrico. Concerning the sale of the existing facility, investment tax credit recapture will be $1.6 million. Additionally, capital gains taxes will be $1.10 million. We do not believe that these revenues will be received if the Bill is not enacted.

4. If a new duplicative facility is built, the new substantial user will obtain approximately $2.8 million of investment tax credits for construction of a new $30 million facility. Agrico can be expected to obtain $1.5 million of investment tax credits from the $15 million expansion of its existing facility. Thus, there would be $4.3 million of investment tax credits under existing law versus only $2 million of investment tax credits if the bill is enacted.

5. The acquisition of the existing facilities will be accompanied by expansion and improvement. The latter will not only help employment in Florida, but will also create demands for items manufactured outside the State of Florida, i.e., there will be a favorable multiplier effect on goods and services from other States.

Summary

The amendment will benefit the nation's balance of payments, will generally increase corporate tax revenues, decrease the revenue loss associated with the investment tax credit and will increase employment in several states resulting in additional income tax. In summary, the increased Federal revenues will be overwhelming when compared to the estimated loss of revenue from the additional bonds.

CONCLUSION

In general, Congress did not intend to limit the incentive provided by section 103(b)(4) for wharfs and docks to only new facilities. In particular, Congress anticipated the Authority expanding the Tampa Port by acquiring and improving existing facilities. Such a course, as in the Agrico case, requires a lease back to the prior owner. To remedy the unintended prohibition contained in the regulations and to discourage duplicative facilities, an amendment to Section 103(b)

(4) is needed which will make it clear that the Authority's program is not "refinancing" as precluded by the regulations.

S. 2548 ensures that Treasury Reg. § 1.103–8(a)(5) will not improperly restrict the Tampa Port Authority from carrying out its responsibility to improve and expand the Tampa Port. In order to solve Tampa's demurrage problem and increase control over the harbor facilities, the Authority needs to acquire and improve this Agrico property. Private business interests are willing to make such a sale to the Authority only if they can continue to stay in business after acquisition by the Authority. Moreover, from the Authority's position, economic viability of future wharves, docks and related facilities, is based upon such companies' expertise and rental payments.

Passage of S. 2548 will provide significant economic benefits to the Tampa Port Authority, State of Florida, and Federal government. Accordingly, we respectfully urge the passage of this bill.

EXHIBIT A: EXCERPTS FROM "AN ECONOMIC FEASIBILITY STUDY FOR TAMPA PORT AUTHORITY" USED BY THE PORT IN ITS NEGOTIATIONS WITH THE CORPS OF ENGINEERS

The Study notes on page 24 the effort by the Authority to provide more and improve existing facilities. Pages 53–55 indicate the need of the authority to deal with inadequate existing facilities. In particular, the Study states that additional loading facilities for phosphate shipments will be needed.

Subsequent to the Study, the contract between the Authority and the United States of America provides as a condition to the United States undertaking the harbor project that the Authority will "c. Provide and maintain at local expense adequate public terminal and transfer facilities open to all on equal terms, and depths in berthing areas and local access channels serving terminals commensurate with the depth provided in the related project areas;". The Authority could not have accepted this condition without the right to issue tax exempt industrial development bonds to acquire land and facilities, improve same, and lease some of them back to prior owners.

The refinancing rule in the regulations as applied to the facts of Tampa Port Authority is wrong. In addition to redressing the general inequities associated with its application, an amendment is required to prevent it from undermining Congressional intent and reducing the Authority's ability to honor its contract with the U.S. Government.

(Excerpts From an Economic Feasibility Study for Tampa Port Authority)

2. *Local cooperation on proposed and prior projects*

The City of Tampa and local interests have been extremely cooperative in providing lands, rights of way, easements, and spoil disposal areas required to improve, expand, and maintain channels and navigational facilities within Tampa Bay. The City of Tampa, in order to insure that adequate areas were available for general commerce, with the approval of the Secretary of War, acquired 700-foot frontages on each side of Ybor Channel and constructed on the west side marginal wharves, a 30-foot-deep slip, a 9,375 square-foot warehouse, and constructed part of a municipal belt-line railroad connecting with Atlantic Coast Line and Seaboard Airline Railroad facilities. A 15,000 square-foot warehouse was erected by the City on the north side of the Garrison Channel, and a site was transferred to the United States Government on Ybor Channel for use as a dredge marshalling area. This site was not used by the Government and subsequently was returned to the City on March 8, 1948. To date, the City of Tampa and Tampa Port Authority have been very cooperative in supporting needed projects for upgrading and expanding the Tampa Harbor area.

During World War II, the Navy Department and the U.S. Government requested that a belt-line railroad and the paving of streets north and east of Ybor Channel be completed to facilitate operations of the Tampa Shipbuilding Company. The paving was completed and a portion of the trackage owned by the Atlantic Coast Line Railroad north of the channel was relocated to City-owned rights of way at the expense of the railroad company. The Seaboard Airline Railroad, however, opposed extension of railroad service to an area that they had served exclusively for years. The Interstate Commerce Commission backed the complaints of the railroad with the result that the Navy Department withdrew their request and the Secretary of War advised the City extension of the belt-line was not required. With these exceptions, the City of Tampa complied with the requirements of the various Acts.

In the Rivers and Harbors Act, approved June 20, 1938, it was suggested that in order for work to be completed in upper Tampa Harbor local interests must furnish free of cost necessary rights of way and spoil disposal areas for new work and continued maintenance. In addition, they should move and reconstruct all bulkheads, wharves, buildings, roads, railroad tracts, and structures as may be necessary and provide the lands necessary to install a breakwater at Peter O. Knight Airport. All of the requests were met by local interests.

The Rivers and Harbors Act, approved March 2, 1945, provided for further improvements in the upper harbor channels of the Hillsborough River, and required that local interests provide free of cost to the United States all lands required for the improvements and the disposal of dredged material during construction and for subsequent maintenance when needed. These included improvements to the Sparkman Channel, Ybor Channel and turning basin, and the Hillsborough turning basin. This bill also required that the City of Tampa agree to complete the construction of the belt-line railroad and the paving of additional streets on the north and east sides of the Ybor Channel. In addition, it requested that new bulkheads and retaining walls be constructed and that all structures be strengthened in order to safeguard both the channels and the adjacent lands and structures. It also stated that the City should make necessary alterations to structures crossing the Hillsborough River in order to protect the United States from claims of damages which result from channel and snagging improvements in the river. It requested that local interests construct and maintain a wharf with adequate depth alongside and a pre-cooling plant with a weekly capacity of not less than 810 tons open to all on equal terms. These improvements were all satisfactorily completed.

In June of 1945, by the authority of Chapter No. 23338 (No. 824) (Senate Bill 804) Laws of the State of Florida, a Hillsborough County Port Authority and Hillsborough County Port District was created to operate independent of the City, County, or State. This authority was the governing body of an area defined as the Hillsborough County Port District, comprising approximately the northwest quarter and part of the southwest quarter of Hillsborough County.

This includes all channel and terminal areas in Tampa and Port Tampa, but excludes the Alafia River, Port Sutton, and the relatively undeveloped area southeast of upper harbor. The Port Authority Board was comprised of five persons, each appointed to his post by the Governor of the State of Florida to serve a term not to exceed four years. Each member, however, would be eligible for reappointment. The Port Authority has been very active in supporting local Corps of Engineers and Government projects. In 1949, the Hillsborough County Port Authority locally sponsored the U.S. Corps of Engineers improvements to Ybor Channel. In this respect, they worked closely with the Corps of Engineers securing rights of way, spoil areas, and local assurances in connection with the work. The Port Authority, with other interested groups, has helped sponsor the Tampa Harbor Project, which provides deeper and wider channels for the Port. This project got under way in November of 1955 with an initial appropriation from the U.S. Congress of $977,000. In this instance, the Port Authority gathered the necessary information including testimony to be used by the various Governmental committees concerning the Tampa Harbor Project.

This Project included deepening the Egmont Channel to 36 feet; the Mullet Key Cut to 34 feet deep and 500 feet wide; the Tampa Bay, Hillsborough Bay, and Port Tampa Channels to 34 feet deep and 400 feet wide; the Port Tampa turning basin to 34 feet deep by 750 feet by 2,000 feet; the Sparkman Channel and Ybor turning basin to 34 feet deep and a channel 30 feet deep, 300 feet wide, including a turning basin 700 feet by 1,200 feet in the Alafia River. The Tampa Port Authority also cooperated with the Government in clearing and deepening the Hillsborough River from its mouth to the City waterworks dam. Their efforts included securing additional rights of way, spoil disposal areas, and local assurances in connection with the work. In 1960, the Port Authority led local interests in cooperating with the Corps of Engineers in the projects for deepening Ybor Channel from 30 feet to 34 feet and the addition of Port Sutton Channel and turning basin to the Federal project for maintenance purposes. In 1963, the Hillsborough County Port Authority, in an effort to promote trade and use of the Tampa Port facilities, changed their name from the Hillsborough County Port Authority to the more familiar Tampa Port Authority.

3. Other improvements

Throughout the years, there have been numerous improvements made to the Tampa Harbor area by local interests. The first improvements began in 1907 when the Tampa Northern Railroad Company dredged a 2,000-foot-long channel 20 feet deep from the main channel to their terminals at Hooker's Point. The westerly portion of this channel, some 50 feet long, officially became part of the Sparkman Channel by the Rivers and Harbors Act approved June 25, 1910.

In 1909, a channel was completed eastward from the Hillsborough turning basin approximately 3,000 feet. This channel, 20 feet deep and 300 feet wide, was constructed at a cost of approximately $95,000, and later became part of the Garrison Channel by the Rivers and Harbors Act approved June 25, 1910.

The Port Tampa Channel has been approved numerous times by the Atlantic Coast Line Railroad, which has extensive facilities at that port.

The Weedon Island Channel, extending from the Port Tampa Channel to Weedon Island, is privately dredged and maintained to a depth of 34 feet.

A 10-foot channel with turning basis was dredged at the shore end of Tampa Bay to a United States Treasury Department quarantine station at Gadsden Point. The cost of these improvements was approximately $80,000.

The initial dredging of a 27-foot channel from Hillsborough Channel to Port Sutton was started around 1930 by the American Cyanamid Company. They abandoned their site and subsequently the property was acquired by local interests.

The Seddon Island facilities, operated by the Seaboard Airline Railroad, have had numerous improvements in recent years. The railroad maintains two slips 36 feet deep on the east side of Seddon Channel, one 900 feet long, the other 1,100 feet long. In addition, they maintain a rail and vehicular bridge over the Garrison Channel.

Numerous local improvements have been made at the Sparkman and Ybor Channels and subsequently much of this work was incorporated into the channel limits. These improvements include 2,000 lineal feet of channel from 20 feet to 30 feet on the west side of Ybor Channel; 800 lineal feet of 27-foot-deep channel on the east side of Ybor Channel dredged by the Texas Company; deepening of the channel in front of the Texas Company wharf in 1946, at a cost of $4,755; improvements by the Tampa Marine Company also located on the east side of Ybor Channel to its marine railway slip of from 22 feet to 30 feet, at a cost of approximately $3,800; improvements by the Tampa Shipbuilding Company to a marginal slip by their facilities of from 24 to 30 feet on the east side of Sparkman Channel, with a portion of these improvements dredged to 42 feet to accommodate a 10,000-ton floating drydock. Other improvements to the east side of Sparkman Channel include approximately 3,500 lineal feet of channel from 26 feet to 27 feet, a slip 18 feet deep, and a 24-foot access channel. The total estimated cost of this work is approximately $230,000. During the early part of the second World War, the United States Maritime Commission constructed a graving dock, three shipbuilding basins, and an outfitting slip with central pier at the Hooker's Point shipyard. All of these channels and improvements had a depth of 23 feet.

Subsequent improvements have been made to the Port Sutton Channel since it was initially dredged to 27 feet in 1929. In 1955, the channel and basin were reportedly dredged to 30 feet, while private mainterance dredging was performed in 1957 and 1960. Port Sutton, Incorporated, has just recently completely the deepening of the channel, basin, and slip to 34 feet.

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The Tampa Electric Company has recently awarded a contract and initiated dredging improvement at their Big Bend plant site on the east side of Hillsborough Bay, five miles north of Ruskin. Site work will include the filling of 320 acres, while the dredging will consist of a channel 35 feet deep and 200 feet wide. The total cost of this contract is estimated in excess of $1,000,000.

4. Terminal and transfer facilities

a. *General.*—Terminal facilities in the Tampa Harbor area are extensive and widespread. These facilities include piers, wharves, transit sheds, warehouses, tank farms, railroad trackage, and other utilities and appurtenances. They also include drydock facilities for repairing vessels, oil and coal bunkerage, water service, fire protection, general refrigeration and bonded storage. General transportation to these facilities is excellent, with good highways and rail facilities available at all sites. An effort has been made by the Tampa Port Authority, since its inception, to provide more available land for expansion and to improve the existing facilities to make them more attractive to prospective users.

b. *Port Tampa.*—All of the terminal sites at Port Tampa are owned by the Atlantic Land and Improvement Company, which is a subsidiary of the Atlantic Coast Line Railroad, and leased to the various users. The terminal facilities are located at the entrance to and on both sides of a dredged slip 34 feet deep and 150 feet to 200 feet wide and 3,800 feet long. The Atlantic Coast Line Railroad operates its phosphate loading facilities on the north side of the slip while the south side is shared by National Gypsum, Shell Oil, Gulf Oil, and Standard Oil. In addition, the Tampa Electric Power Company and the Hardeway Contracting Company each operate a pier at the entrance to the slip. The Atlantic Coast Line Railroad is the sole operator in and out of this port facility. Adequate rail siding capacity at shipside and yard marshalling are available. Ample highway connections are convenient to Tampa.

c. *Alafia River.*—The U.S. Phosphoric Products Corporation operates an extensive terminal facility at the mouth of the Alafia River and is served exclusively by the Atlantic Coast Line Railroad.

d. *Seddon Channel.*—The most southerly terminal is comprised of the phosphate loading facilities of the Seaboard Airline Railroad, while the Blocks Terminal is located in the northwest corner of Seddon Island. The Seaboard Airline Railroad serves this complex.

e. *Garrison Channel.*—The Garrison Channel has numerous facilities located along its north and south shoreline. The south side of the channel is occupied by the Tampa Bay Terminal and by the Hillsborough County Health Department. The Tampa Bay Terminal facilities consist of wharves, transit sheds and warehouses. The Hillsborough County Health Department has a channel and a wharf which are not used for handling water-borne commerce. The north side of the Garrison Channel contains terminal facilities for the Luckenbach Steamship Company, the Tampa Import and Export Terminal, Cargill, Sun Oil Company, Bull Steamship Lines, and Tampa Sand and Material Company. Facilities on the south side include wharves, transit sheds, warehouses, grain handling facilities and petroleum product storage. Both the Atlantic Coast Line and the Seaboard Airline Railroads serve these facilities.

f. *Ybor Channel.*—Terminal facilities are located on both sides of the Ybor Channel. The major operators of these facilities include Gulf Florida Terminals Company, the Municipal Terminals, Tampa Terminals, Inc., Tampa Marine Company, Phillips Petroleum Company, American Bitumuls and Asphalt Company, and the Texas Company. These terminals are capable of handling general cargo, sulphur, potash, ammonium sulphate, petroleum products both bulk and packaged, and general outfitters for repairing and mooring small vessels. These facilities are served by both the Atlantic Coast Line and the Seaboard Airline Railroads. Ample highway facilities are available to all the terminals.

g. *Sparkman Channel.*—Seddon Island is not developed on the west side of Sparkman Channel for handling water-borne transportation. Instead, the port terminals are located on the east side of the channel. These facilities include: the George B. Howell Maritime Center, the Tampa Electric Company, the Florida Portland Cement Company, the Sinclair Refining Company, the American Oil Company, the Freeport Sulphur Company, the Tampa Ship Repair and Drydock Company, the Tampa Port Authority, and the River-Gulf Terminal, Inc. Facilities are available for mooring, outfitting, and repairing vessels, the handling of dry raw materials such as gypsum and sulphur, general cargo and petroleum products, including bulk petroleum storage and general dry goods and cargo. Berthing spaces along the channel have been dredged to a depth from 20 feet to 34 feet. The terminals in this area are served exclusively by the Seaboard Airline Railroad with numerous highway connections into Tampa.

h. *Hillsborough River.*—Along the Hillsborough River, between its mouth and the Lafayette Street Bridge, are the terminals of Bay Dredging and Construction Company, the Steamways Corporation, the Felicone & Sons Fish Company, the Gulf Oil Corporation, Knight and Wall Company, Tampa Electric Company, and the Mirabella Fish Company. All of these facilities are equipped to handle shallow-draft vessels. Ready highway access is available to the City and the Atlantic Coast Line Railroad furnishes the rail transportation.

i. *Port Sutton.*—Port Sutton is located on the east side of Hillsborough Bay and is a facility owned by Port Sutton, Incorporated. Tenants at this port include the Florida Phosphate Terminal Corporation, the Pan American Sulphur Company, Grace Company, Ideal Cement and Morton Salt. The Tampa Electric

Company has a plant on the north side of the site which they own. The Florida Phosphate Terminal Corporation has recently completed a phosphate processing, storage, and shipping facility which includes outdoor storage for about 180,000 tons of undried phosphate rock, a chemical storage silo with 65,000-ton capacity, and a 6,240-ton-per-day dryer. Loading facilities are rated at 1,800 tons per hour and have exceeded 2,300 tons per hour over short periods. This facility is served exclusively by the Atlantic Coast Line Railroad. Although the Corps of Engineers has authorized channel and turning basin maintenance to 30 feet, all improvements to date have been privately financed and have been deepened to 34 feet.

5. Difficulties Attending Navigation

An overall review was made of navigational problems in Tampa Harbor. It established the fact that difficulties presently encountered by ships serving Tampa's ports are not generally the result of lack of markers, wind or tides, but, rather, maintenance and the obsolescence of the existing channel dimensions to accommodate the larger vessels presently serving this port. The Tampa Bay Pilots have aptly summarized these problems with the following statement: "With regard to the need for channel and harbor improvements and the inability of the channels to accommodate certain vessels with full cargoes, we believe two facts become immediately apparent: First, the depths and widths of the existing channels and turning basins are presently being utilized to their maximum limits.

(Page 53–55)

	Under 10,000	10,000 to 16,999	17,000 to 29,999	30,000 to 49,999	50,000 and over	Total
1962 ----------------	9.7	10.5	34.2	37.6	8.0	100
1963 ----------------	8.6	8.9	32.0	38.	12.5	100

During the year 1963 only, the portion of world carrying capacity in ships of under 17,000 dwt declined by 2.7 percentage points, while the portion in tankers of 30,000 dwt or more increased by 4.9 percentage points. There is little doubt that the trend will continue to be toward larger and deeper draft tankers and ore carriers.

The German transportation company, Unterweser, one of the largest companies engaged in the ocean transportation of bulk phosphate, has ordered three giant ore carriers specifically for the phosphate trade. These vessels with a cargo capacity of 35,000 tons and a draft of 35 feet 8 inches, will be calling on the Tampa Harbor. The first vessel, the HAHNENTOR, is scheduled to arrive in Tampa Harbor June 1, 1965, with the sister ships following in the fall.

6. Trends in terminal development

Like several other harbors in rapidly growing areas, Tampa Harbor is entering into a transitional period in which the needs for efficient port terminal services are accumulating faster than its ability and capacity to accommodate them satisfactorily. This is an almost inevitable consequence of extensive economic growth of the tributary area, advances in terminal operation and handling methods, trends in vessel sizes, obsolescence of existing facilities, and encroachment of higher land usage in adjacent areas. Most of these elements are already in evidence here.

Area economic growth has been a major influence in boosting harbor commerce several-fold. Many of the aging terminals are not adaptable to modern, efficient equipment and methods nor do they have the needed room for expansion. The physical layout and dimensions of the harbor channels and basins limit the port's ability to accommodate the new larger and more economical vessels. Obsolescence of many of the existing terminal facilities discourages further growth in harbor commerce as well as port-dependent industrial development. Encroachment of higher land usage and the increase in community objections to nuisance characteristics of port operations limits further expansion of port terminals.

It would appear that the first steps in the transition towards modern and adequate terminal facilities have been started. The general planning of the Tampa Port Authority for the expansion and development of the Hooker Point area may be considered an initial step in this direction. The development of extensive terminal facilities by private interests in the Port Sutton area constitutes an already accomplished step toward the desirable objective of adequate freight handling in Tampa Harbor.

Much more needs to be done, however, and it should be done as quickly as feasible, if Tampa Harbor is to maintain its place as the principal shipping and receiving point for the water-borne commerce of the greater part of the western half of the Florida peninsula. Some of the older facilities have reached a stage of obsolescence which can only result in abandonment or complete rebuilding in a short period of time. Such instances usually are found in locations where land access or water access, or both, are so badly congested that rebuilding and modernizing the obsolete facilities would not be warranted. Oil terminals are now scattered throughout the harbor area, at Port Tampa, and along the already congested Sparkman, Garrison and Ybor Channels in the inner harbor. With the very large added volume of petroleum products which will be needed to meet the demands of the high population growth of the tributary area, it appears inevitable that these terminals must gradually move to new locations where ample space is available, and fire hazards and community objections may be held to a minimum.

Existing phosphate terminals are widely dispersed. In some instances, they are highly conducive to community objections from the standpoint of dust and noise during loading operations, and serious interference with vehicular traffic at railroad crossings during the transfer of phosphates by rail from the mines to the ship loading terminals. The railroad-owned loading facilities have insufficient capacity to load the new larger carriers quickly enough to take full advantage of the economies obtainable with these vessels. A careful review of the outlook for future phosphate shipments leads to the conclusion that additional loading facilities with greater capacities will soon be needed. This opens up the opportunity for the installation of additional facilities in a more suitable location along the east shore of Hillsborough Bay.

EXHIBIT B: REVENUE ESTIMATE FOR S. 2548

I.—ASSUMPTIONS

A. Treasury's informal estimate of the loss of revenue associated with the issuance of tax exempt industrial development bonds ($2.50 to $3.00 per $100.00) is accurate.

B. The $15 million required for improvements at Big Bend solely for Agrico can be financed without the amendment; $20 million required for expansion and improvements by Big Bend for Agrico and a new substantial user can be financed without the amendment.

C. The acquisition of 100 acres of land for $3 million can be financed without the amendment.

D. No value has been assigned to the increase in foreign commerce and the favorable impact upon the balance of payments.

E. No value has been assigned to the jobs created by construction and improving facilities.

F. Ten to twenty percent of the gross revenues associated with gross phosphate sales is subject to Federal income tax.

G. There is no estimate of the reduction in the Port Authority's interest costs on its general revenue obligations.

H. If S. 2548 is not enacted, a new duplicative facility will be constructed for the new substantial user at a cost of $30 million which will generate a $2.8 investment tax credit. Similarly, $15 million of improvements for Agrico will produce a $1.5 million investment tax credit. Thus, without the amendment, $4.3 million of investment tax credits will be generated. With passage, there will be an investment tax credit only upon the $20 million of improvements of $2 million.

II.—ECONOMICS

A. Tampa Port Authority—Benefits

1. Approximately $500,000 net revenue will be generated annually by dockage and wharfage charges on the movement of phosphate and related products in and out of the new and improved Big Bend Terminal Faciltiies.
2. Unencumbered real estate valued at $3 million will be used for further Port development.
3. Unencumered title to the property will inure to the Port Authority.

B. State of Florida—Benefits

1. The State will receive an additional $314,000 in sales tax from the $20 million expansion.

2. The State will also receive an additional indefinite annual severance tax of $4.2 million per year.

C. Federal Government—Benefits and Detriment

1. The annual revenue loss will be between $450,000 and $540,000 ($18 million x 2.5 percent and 3.0 percent) for the term of the bonds.

2. An indefinite annual revenue gain from a federal tax of $3.22 million to $4.6 million results from the elimination of demurrage costs of $7 to $10 million.

3. An indefinite annual revenue gain of between $8,050,000 and $16,100,000 will result from an additional $175 million of phosphate sales ($175 million x 10 percent and 20 percent x 46 percent rate).

4. There will be an investment tax credit recapture of $1.6 million and a capital gains tax of $1.10 million.

III. SUMMARY

	Low	High
A. Annual revenue gain during term of bonds:		
Port Authority revenue gain	$500,000	$500,000
State severance tax	4,200,000	4,200,000
Revenue gain, elimination of demurrage charges	3,220,000	4,600,000
Federal tax from $175,000,000 additional phosphate sales	8,050,000	16,100,000
Subtotal	15,970,000	25,400,000
IDB, revenue loss	450,000	−540,000
Total indefinite gain per annum	15,520,000	24,860,000
B. 1 yr extraordinary benefits:		
Recapture investment tax credit	1,600,000	
Capital gains tax	1,100,000	
State sales tax	314,000	
100 acres to port	3,000,000	
Difference in availability of investment tax credit	2,300,000	
Total	8,314,000	
C. 1 yr Federal revenue gain:		
IDB revenue loss	(450,000.	(540,000)
Recapture investment tax credit	1,600,000	1,600,000
Capital gains tax	1,100,000	1,100,000
Total	2,250,000	2,160,000

Note: The net benefits to the Authority, State, and Federal Government are readily apparent.

Mr. Rostenkowski. I have one question, but I think we will recess until such time as the members have voted. We have a rollcall on now. The committee will stand in recess for 10 minutes.

[A recess was taken.]

Mr. Rostenkowski. The committee will resume its sitting.

Mr. Lee, what would be the annual benefit to Agrico from the proposed transaction, having the $40 million on tax-exempt debt issued for its benefit. What would be the annual benefit that Agrico would enjoy?

Mr. Lee. Since Agrico would be covering a debt service on the bonds which involve the acquisition as part of the transaction, that would be to their benefit. However, I think it should be pointed out that there would be some recovery in the form of investment tax credits and capital gains, which would be recouped by the Federal Government in the matter, sir.

Mr. Rostenkowski. I am trying to determine in this case the distinction from other refinancing of other exempt facilities. In light of the fact that the new substantial user requirement of the bill can be met by giving up only 5 percent of the facility to an unrelated person. I am trying to distinguish in my own mind how, if we set a precedent here, we are not setting a precedent for future situations in the same area.

We have indicated in this committee great concern about refinancing. Could you comment to me on that, Mr. Lee?

Mr. LEE. Well, if I can comment on this specific case, sir. The Agrico terminal that is under consideration here is substantially underutilized at the present time. At the same time, in order to get other users into that terminal, it is necessary for us to go through the transaction we are considering here today. That is to say, we would acquire it from Agrico and lease it to a joint venture in which there would be other users of the terminal.

Within this context, the use of this terminal would more than double. The other substantial user—and we have been involved in talks with other substantial users, or prospective substantial users—the other substantial user would put more product through that terminal initially than Agrico is putting through now on *its own*. This would be of major benefit to the port.

The alternative is, I am sure, that if this financing cannot be worked out, the other substantial user has a more favorable alternative to go elsewhere in the port complex and build his own terminal, creating perhaps another underutilized terminal within the port, and using up other deep-water land, or land on deep water which is also a diminishing resource in the port.

From our standpoint, as the public body whose mandate it is to promote and develop the port, we see the expansion of the Agrico terminal, the bringing in of other substantial users, increasing of the capacity of that terminal as having an impact on reducing congestion in the port, having a distinct public purpose.

Mr. ROSTENKOWSKI. What is the total amount of acreage involved in this transaction, Mr. Lee?

Mr. LEE. It is approximately 250 acres.

Mr. ROSTENKOWSKI. Is that what the port needs, does it need the entire 250 acres?

Mr. LEE. I am sorry, sir.

Mr. ROSTENKOWSKI. Is that what the port needs, does it need that entire total acreage?

Mr. LEE. Well, part of the package that we have negotiated with Agrico would result in the port acquiring in *fee* 100 of those acres. The residual, or approximately 150 acres, would evolve into the terminal used by the Agrico and the new substantial users in the joint venture. That 100-acre parcel that we would acquire would be for future port development by some other enterprise, the only restriction being that it would be compatible with the phosphate terminal which is located in the same general area.

Mr. ROSTENKOWSKI. Well, the proportionate cost of the land is what percentage of the $40 million?

Mr. LEE. I am sorry, sir.

Mr. ROSTENKOWSKI. What is the proportionate disbursement of dollars for the 250 acres of land that you would purchase?

Mr. LEE. I am not sure I follow you, sir. The appraisal on the property——

Mr. ROSTENKOWSKI. Well, the total bond issue is $43 million.

Mr. LEE. Right.

Mr. ROSTENKOWSKI. What would be the division of the dollars disbursed; (1) for the improvement of the facility; and (2) for the land purchase?

Mr. LEE. That $43 million is for the acquisition of the existing facility, based on the appraisal of the use of the facility now. This envisions an additional bond issue of approximately $20 million for improvements over and above the $43 million acquisition. I think you should understand, sir, that Agrico now handles a commodity known as wet rock, it is rock that comes from the mines in a wet state. They do not handle any dry rock, which is another form of handling phosphate rock. The new substantial user that would come into this joint venture handles dry rock. This requires that the installation be quite substantially modified with covered storage to house the dry rock in other facilities and to take care of it, load it aboard ships, rail car dumpers, and the like.

It would also double the capacity of the terminal for handling finished fertilizer.

Mr. ROSTENKOWSKI. Thank you very much, gentlemen.

Mr. FOX. Mr. Chairman, I am also part of the panel and would like to mop it up, if I could.

Mr. ROSTENKOWSKI. Mr. Fox?

Mr. FOX. Yes.

Mr. ROSTENKOWSKI. I am sorry.

STATEMENT OF H. LAWRENCE FOX, COUNSEL, ON BEHALF OF DAVID FYFE, DIRECTOR OF COMMERCIAL DEVELOPMENT, AGRICO CHEMICAL CO.

Mr. FOX. That is all right. My name is Larry Fox and I am a member of the Law Firm of Dawson, Riddell, Fox, Holroyd & Wilson. I appear today on behalf of the Agrico Chemical Co. in support of H.R. 5847.

Dr. Fyfe, director of commercial development for Agrico is unfortunately out of the country and unable to testify, as he did before the Senate Finance Subcommittee on S. 2548, the comparable Senate bill.

Agrico, a substantial producer of phosphate rock from Florida and a major manufacturer of fertilizers, is heavily involved in the highly competitive domestic and international trade of phosphate fertilizer materials. The company supports this bill and endorses the Tampa Port Authority testimony. Without this amendment. maximum use will not be made of Agrico's Big Bend phosphate terminal.

Further, Agrico's demurrage costs, along with those of other shippers in the port, will continue to rise.

Finally, the authority will not be able to expand and improve the port through its proposed acquisition of Agrico's facilities and vacant land.

In the past several years, ships loading phosphate and fertilizers at Tampa have increasingly been subjected to delays from port congestion which causes mounting demurrage charges to shippers and their customers. The solution is to expand existing port facilities. This will relieve congestion and allow for projected future growth.

Thus, the authority has been negotiating with Agrico to buy its terminal and approximately 100 acres of adjacent deep water-front land suitable for future expansion. The Big Bend terminal is underutilized in that it can handle increased ship loadings, but must be expanded and substantially changed to provide the capacity to ship phosphate materials it cannot presently handle.

For Agrico, expansion is economic only if one or more new substantial users can be found. The company believes that the best long-term solution to the congestion in other terminals, coupled with the underutilization of Big Bend is the proposed purchase by the authority. However, the Treasury regulations preclude the transaction from tax-exempt financing. As a result, potential new substantial users will not choose to use Big Bend since they can build a new, but duplicative facility, financed entirely with tax-exempt bonds elsewhere.

The justification for this proposed transaction are ample, and effectively precluded by Treasury regulations from the proposed transaction to the detriment of the port and its users.

At the May 30 hearing before the Senate Finance Subcommittee, Treasury testified that it opposed S. 2548 only in its present form. It also stated that the regulations which are intended to prevent refinancing should be re-examined and clarified in the case of a renovation or rehabilitation. The company applauds Treasury's recognition that present regulations need correction. Both the Treasury and this committee should note that there are a number of reasons why, as a matter of substance and policy, H.R. 5847 does not qualify as refinancing and seems to be consistent with previously expressed Treasury rationale.

1. The Authority would acquire immediate title to the property, unencumbered at the end of the lease term.

Present law does not preclude this transaction, but rather Treasury regs are the barrier.

2. The bill requires that the terminal be shared with at least one new substantial user.

3. The terminal would be substantially renovated by the authority to more than double its shipping capacity and to permit shipment of products which now cannot be shipped. The new products would account for over 50 percent of the new facility's throughput.

4. The cost of the renovation—$23 million—is more than 50 percent of the cost of the port authority to acquire the existing facility—$43 million.

5. A significant portion of the transaction could already be accomplished under existing regulations. That is, the bill would not foster the transaction but simply allow its completion.

6. Prior regulations qualified the entire transaction. The changed regs were not pursuant to a change in the code.

Thus, after its acquisition and improvement, the facility for all practical purposes is a new one. There will be a different owner; a new substantial user; expanded capacity, as well as shipments of new products. Simply stated, the bill removes the economic disincentive that Treasury regulations pose to attracting new substantial users to the existing facility.

The justification for this proposed transaction are ample, and accordingly H.R. 5847 should be passed, notwithstanding Treasury's philosophical objections to industrial development bonds.

In conclusion, the transaction would substantially reduce shipping delays and the consequent tax-deductible demurrage expenses, increase shipping capacity in the Port of Tampa, and make U.S. fertilizer products more competitive in world markets in terms of both cost and reliability of supply. These benefits, in conjunction with the cost to Agrico which are (1) a recapture of investment tax credits; (2) capital gains taxes, and (3) wharfage payments to the authority substantially in excess of debt service, make it clear that the total transaction is for sound public purposes.

It is thus not a refinancing which the Treasury regs were intended to prohibit.

Finally, as the authority has indicated, both the State of Florida and the Federal Government would derive increased on-going revenues as a result of the transaction. In particular, the taxes that Agrico would pay in the year of the sale to the authority exceed $2.5 million, substantially more than the alleged $500,000 revenue loss from issuance of additional bonds.

We therefore urge the committee to approve H.R. 5847.

[The prepared statement follows:]

STATEMENT OF DR. DAVID FYFE, DIRECTOR OF COMMERCIAL DEVELOPMENT, AGRICO CHEMICAL CO., AND H. LAWRENCE FOX, ESQ., ON BEHALF OF AGRICO CHEMICAL CO.

Agrico Chemical Company, a substantial producer of phosphate rock from Florida and a major manufacturer of fertilizers, is heavily involved in the highly competitive domestic and international trade of phosphate fertilizer materials.

Agrico supports H.R. 5847 and endorses the testimony submitted by the Tampa Port Authority. Without this amendment, maximum use will not be made of Agrico's Big Bend Phosphate Terminal and Agrico's demurrage costs, with those of other shippers in the Port, will continue to rise. The Authority will not be able to expand and improve the Port through its proposed acquisition of Agrico's facilities and vacant land.[1]

THE PORT OF TAMPA BAY TODAY—BACKGROUND

In the past several years, ships loading phosphate rock and fertilizers at Tampa have been subjected increasingly to delays from port congestion causing mounting demurrage charges to shippers and their customers. The solution is to expand existing port facilities. This will relieve congestion and allow for projected future growth. For this reason, the Authority has been negotiating with Agrico to buy its Terminal and approximately 100 acres of adjacent waterfront land, suitable for future expansion.

AGRICO'S POSITION

Big Bend terminal is underutilized because it can handle increased ship loadings, but it must be expanded and substantially changed to provide the capacity to ship phosphate materials it cannot presently handle. Expansion is economic only if one or more new substantial users can be found.

Agrico believes that the best, long-term solution to the congestion at other terminals coupled with the underutilization of Big Bend is the proposed purchase by the Authority. The Treasury regulations disqualify this transaction from tax exempt financing. As a result of these regulations, potential new substantial users will not choose to use Big Bend when they can build a new facility financed entirely with tax exempt bonds. Thus unless H.R. 5847 is passed, Agrico and the Port Authority are effectively precluded from the proposed transaction to the detriment of the Port and its users.

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[1] A copy of the written statement on S. 2548 (identical to H. R. 5847) that was submitted to the Senate Finance Subcommittee on Taxation & Debt Management Generally for its May 30, 1980 hearing is attached as part of the testimony before this Committee.

TREASURY POSITION

At the May 30th hearings before the Senate Finance Subcommittee, the Treas
ury Department testified that it is opposed to H.R. 5847 in its present form. How
ever, Treasury stated:

> "We believe that the use of tax exempt borrowing for the rehabilitatio
> of exempt facilities, accompanied by appropriate safeguards, may well b
> justified in certain cases. Policy in this regard should certainly be reex
> amined and clarified."

We applaud the Treasury's recognition of a problem with the present regula
tions. There are a number of reasons why as a matter of substance and polic
the proposed transaction is not a refinancing:

1. The Authority would acquire immediate title to the property, unencumbere
at the end of the lease term.

2. The bill requires that the terminal be shared on a joint venture basis wit
at least one new substantial user.

3. The terminal would be substantially renovated to more than double it
shipping capacity and to permit shipments of products which cannot presently b
shipped. The new products would account for over 50 percent of the "new" facil
ity's throughout.

4. The cost of the renovation ($23 million) is more than 50 percent of the cos
to the Port Authority to acquire the existing facility ($43 million).

Thus, the facility after its acquisition and improvement for practical purpose
constitutes a new facility with a different owner, new substantial user, expande
capacity and shipments of new products. The bill removes the economic disincen
tive that the Treasury Regulation poses to attracting new substantial users t
the existing facility. The justifications for this proposed transaction are ampl
and accordingly H.R. 5847 should be passed without waiting for broader polic
decisions in this area by the Treasury.

BENEFITS FROM TRANSACTION

In conclusion, the transaction would substantially reduce shipping delays an
the consequent tax-deductible demurrage expenses, increase shipping capacity i
the Port of Tampa and make U.S. fertilizer products more competitive in worl
markets, in terms of both cost and reliability of supply. These benefits, in con-
junction with the costs to Agrico, that is, recapture of investment tax credits
capital gains tax and wharfage payments to the Port Authority by Agrico sub-
stantially in excess of debt service, make it clear that the total transaction is fo
commercial and public purposes. It is thus not a "refinancing" of existing facil-
ities which the Treasury Regulation was intended to prohibit.

Finally, as the Tampa Port Authority has indicated, both the State of Florid
and the Federal Government would derive increased ongoing revenues as
result of the transaction. In particular, the taxes that Agrico would pay in the
year of the sale to the Authority exceed $2.5 million, substantially more than the
alleged $500,000 revenue loss from issuance of the additional bonds.

Statement of Dr. David Fyfe, Director of Commercial Development, Agric
Chemical Co., and H. Lawrence Fox, Esquire, on Behalf of Agrico Chemica
Co., Presented to the Senate Finance Subcommittee on Taxation & Deb
Management Generally

SUMMARY

Agrico Chemical Company, a substantial producer of phosphate rock from
Central Florida mines and a major manufacturer of fertilizers, is heavily in-
volved in the highly competitive domestic and international trade of phosphate
materials.

Agrico supports S. 2548 and endorses the testimony submitted by the Tampa
Port Authority at this hearing. Without this amendment, Agrico will not be able
to maximize the use of the Big Bend Phosphate Terminal and its demurrage costs
will continue to rise. Without this amendment, the Authority will be unable to
expand and improve the Port of Tampa through its proposed acquisition of Agri-
co's existing terminal facilities and vacant waterfront land at the Port.

THE PORT OF TAMPA TODAY—BACKGROUND

The Port of Tampa today ranks as the 7th largest port in the United States. Phosphate materials comprise more than 50 percent of all shipments through the Port. In the past several years, ships loading phosphate rock and fertilizers at Tampa have been subject increasingly to delays resulting in mounting demurrage charges to shippers and their customers as a result of port congestion. In the summer of 1979, for example, ships were taking up to 15 days in the Port compared to an optimum of 3 days with no congestion. The reasons for these increasing delays are, principally, an increasing volume of shipments[2] and a shift in the pattern of trade to a higher proportion of fertilizers, a commodity which is slower to load than phosphate rock.

	1976	1977	1978	1979
Rock	16.1	19.9	19.4	20.8
Fertilizers	2.4	2.9	4.6	4.9
Total	18.5	22.8	24.0	25.7

As the Florida phosphate industry seeks to maintain its competitiveness in the international marketplace against off-shore phosphate rock suppliers, such as Morocco, these increased costs from demurrage are of serious concern given mounting freight differentials caused by rising energy costs and distance from the export markets. The industry is also concerned that these delays in shipping from the Port of Tampa threaten our reputation and capability as a reliable supplier to international customers. For instance, in 1979, one of Agrico's major international customers was twice within 24 hours of running out of dry phosphate rock supplies due to loading delays at other Tampa terminals. The financial consequences of such a failure to supply a key raw material to a world-scale fertilizer plant make the Tampa Port Authority's estimate of $7 million to $10 million in annual demurrage costs at the Port, as a whole, pale in comparison.

It has been recognized by the Port Authority and a number of shippers at the Port that the key to a solution of the demurrage problem facing all users of the Port is the expansion of the existing port facilities. Such an expansion is necessary both to relieve the present congestion and to allow for future growth at the Port. For this reason, the Tampa Port Authority has been negotiating for some time with Agrico to buy Agrico's Big Bend Phosphate Terminal at East Bay Tampa along with approximately 100 acres of adjacent waterfront land which is suitable for future expansion by the Authority.

AGRICO'S POSITION

Agrico's Big Bend Phosphate Terminal ships 2.8 million tons of phosphate rock and 0.4 million tons of fertilizers per year with no vessel delays. Without expansion and improvements, Agrico's other phosphate shipping cannot be handled at Big Bend. An additional 2.3 million tons of phosphate rock is shipped through other Tampa terminals where substantial delays are experienced due to congestion. The problem for Agrico is that the Big Bend Terminal is underutilized in that it can handle increased ship loadings, but its terminal and other segments of the infrastructure must be expanded to handle the additional phosphate materials. It is economic to undertake this expansion only if one or more new substantial users can be brought in to use the Big Bend facility. Following such expansion, the Big Bend facility can handle up to 5 million additional tons per year of dry phosphate rock which provides the capacity needed for a new substantial user. The capital investment so required would be substantially less than the investment if a new terminal is built to handle the same volumes generated by the new substantial user.

Agrico believes that the best, long-term solution to the demurrage problem and the underutilization of Big Bend is the proposed purchase of the terminal by the Port Authority. The Authority would undertake an expansion of these facilities, leasing back the old and new facilities to Agrico and at least one other substantial user. In its search for other substantial users for the terminal after its sale and expansion, Agrico has become aware of the barrier presented by the Treasury Regulation, § 1.103-8(a)(5), which disqualifies the proposed purchase from tax exempt financing by the Port Authority if there is a leaseback to a joint venture that includes Agrico. It is this disqualification that S. 2548 is intended to remove.

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[2] Phosphate shipments from Tampa (million short tons):

This regulatory provision is a barrier because potential new substantial users will not choose to use Big Bend when they can build a new facility financed entirely with tax exempt bonds under existing law and regulations. In other words, it is more economic for a substantial user to build new, duplicative facilities than to make the lesser commitment to participate with the Authority in an expanded Big Bend Terminal. Thus, Agrico and the Port Authority are effectively precluded from obtaining a new user for this project which, in turn, one, eliminates the full use and improvement of Big Bend, two, impedes the Authority's plans for solving the demurrage problem, and three, prevents orderly growth of the Port. While Agrico is willing to sell its property to the Authority to achieve these results, it is unable to do so where it is precluded from leasing back the facilities which are needed to handle its shipping requirements.

Finally, it should be noted that the Big Bend facility offers particular advantages for both immediate expansion and future growth. Much of the Port of Tampa is an environmental "non-attainment" area, which imposes severe limitations on the ability to expand existing facilities in those areas. However, Big Bend is outside the non-attainment area and can be expanded substantially while remaining within all environmental limits.

BENEFITS FROM TRANSACTION

From Agrico's standpoint, the cost savings from the resulting increase in the efficiency of the Big Bend Terminal and the Port of Tampa as a whole, make this a desirable transaction. The transaction would substantially reduce Agrico's demurrage costs, increase its capacity to ship from this facility and make U.S. fertilizer products more competitive in the world market. These benefits, in conjunction with the costs to Agrico, i.e., recapture of investment tax credits, capital gains tax and use payments in excess of the debt service, make it clear that the total transaction is for commercial and public purposes. Further, if the Authority acquires and improves Big Bend, there would be a substantial change in its nature because the facility will handle dry phosphate rock as well as wet rock. It is thus not a "refinancing" of existing facilities which the Treasury Regulation was intended to prohibit.

From the Authority's standpoint, the proposed transaction benefits the Port of Tampa by improving the efficiency of the Port, reducing the demurrage problem, acquiring Agrico's existing facilities and vacant waterfront land for future expansion, and increasing its net revenues available for other projects.

As the Tampa Port Authority has indicated in its statement, both the State of Florida and the Federal Government would derive increased revenues as a result of the transaction.

CONCLUSION

Enactment of S. 2548 will aid the entire phosphate industry using the Port of Tampa solve a serious hindrance to its future business success of predominantly export markets. Agrico is clearly one of the beneficiaries. Moreover, all governmental bodies (Tampa Port Authority, State of Florida, and Federal Government) will derive increased revenues from the sale and expansion of Agrico's Big Bend Terminal.

In order that these benefits can be achieved, we respectfully urge that S. 2548 be passed at the earliest practicable time.

[The following was subsequently received:]

WASHINGTON, D.C., *June 23, 1980.*

Hon. DANIEL ROSTENKOWSKI,
U.S. House of Representatives,
Rayburn House Office Building,
Washington, D.C.

DEAR MR. CHAIRMAN: At your June 19 Subcommittee hearing on H.R. 5847, prior to the temporary adjournment, you asked for a description of the benefits to Agrico Chemical Company from the bill's passage. Since you were unable to return in time for Larry Fox, the member of my firm, who testified on behalf of Agrico, I thought it would be helpful to list the benefits as well as the costs to Agrico that would result from passage:

DIRECT FINANCIAL AND OTHER BENEFITS

1. Agrico would receive approximately $43 million from the Port Authority for the purchase of the existing terminal facilities, including some 70 acres of land on which these facilities are situated.

2. Agrico would receive approximately $3 million for some 100 acres of currently undeveloped adjacent deepwater waterfront land which the Authority needs for future development. The $43 and $3 million figures represent the fair market value of the respective properties, as determined by an independent appraisal. These figures were established a year ago and will not be changed to reflect subsequent increases in value.

3. Once the Port Authority completes the expansion of the terminal, congestion at the entire Port will decrease, resulting in a lessening of the tax-deductible demurrage expenses incurred today by Agrico and other shippers.

4. The lessening of demurrage delays will also protect Agrico's reputation in the domestic and international marketplace as a reliable and timely supplier of phosphates.

COSTS TO AGRICO

1. The sale of the existing facilities to the Authority will require Agrico to pay approximately $2.7 million in taxes to the U.S. Treasury—$1.6 million for the recapture of investment tax credits and $1.1 million in capital gains. Please see the attached copy of a letter to the Joint Committee Staff for further amplification of the benefits of this legislation to the U.S. and Florida treasuries. *Also note that the Bill passage will provide for only $18 million of additional bonds.*

2. Together with the new substantial user, Agrico must guarantee debt service on the bonds used to acquire the facility ($43 million) and to undertake the expansion ($23 million).

3. As a result of the sale of the existing facilities to the Authority and the addition of at least one new substantial user, Agrico will be giving up not only its title in, but the total control it now exercises over the use of these private terminal facilities. Moreover, as a public terminal, all persons desiring to use the facility may do so whenever there is available capacity.

4. As a result of the sale of the undeveloped land to the Authority, Agrico will be giving up its present flexibility either to expand its facilities onto this property or to control the property's future development.

5. Together with the new substantial user, Agrico will guarantee to the Authority revenues from dockage and wharfage of at least $500,000 charges in excess of the debt service. These are charges which, as the owner of the terminal today, Agrico does not now pay.

Agrico is willing to undertake this transaction and the resulting costs because it sees the sale with expansion and leaseback, as the best way to solve the substantial demurrage problem at the Port. This transaction will equally benefit both the Authority, by giving it title and greater, direct control over harbor facilities, and other shippers who are also experiencing this costly demurrage problem.

Finally, I would like to note that the Treasury in its testimony on the Senate side was opposed to this bill "only in its present" form. At your Subcommittee, the Treasury continued to assert that its regulations need revision but opposed H.R. 5847. We are unable to explain Treasury's reversal since the facts of this case have not changed.

We would be pleased to provide you with additional answers to any questions you may have with respect to this legislation.

Sincerely yours,

JAMES W. RIDDELL.

Mr. VANDER JAGT. I would like to thank members of the panel for their testimony. Thank you very much for being here this morning.

The next witness is Congressman Bud Brown of Ohio. Is he here in the committee room? If not, we will move to testimony on H.R. 4175.

I would like to welcome the members of the panel and you may proceed in any order you desire.

STATEMENT OF EDWARD G. MAAG, GENERAL COUNSEL, THE IMPERIAL COUNCIL OF THE ANCIENT ARABIC ORDER OF THE NOBLES OF THE MYSTIC SHRINE FOR NORTH AMERICA

Mr. **Maag.** Thank you so much. My name is Edward G. Maag. I am an attorney at law. I am the general counsel for Shriners Hospitals for Crippled Children, a Colorado corporation, and the Imperial Council of the Ancient Arabic Order of the Nobles of the Mystic Shrine, an Iowa corporation, which is our fraternal corporation.

I appear here today in my capacity as general counsel for the fraternal corporation, the Iowa corporation, in support of the adoption of H.R. 4175.

I have placed on file a written statement of our position and I ask that it be received and filed appropriately.

Mr. **Rostenkowski.** Without objection, it is so ordered.

Mr. **Maag.** Thank you.

In addition to that written statement, I have some observations based upon the testimony of the representative of the Treasury Department and certain other individuals, concerning the effect of this bill, and to use the phrase that my colleague from the Treasury Department used, "To discuss the appropriateness of the bill." I think he said it was inappropriate. I suppose almost anything could be disposed of with that word, but I respectfully submit that the facts demonstrate rather clearly that it is an appropriate measure and is in the public interest.

I notice that the staff of the joint committee in their analysis of the revenue effect of this bill have estimated that the bill would reduce the budget receipts by $5 to $10 million annually. If that estimate is correct, and I would certainly defer to the staff's knowledge in this regard, if that estimate is correct, I respectfully submit that the public benefit derived to the public generally only from the Masonic fraternity annually—not all fraternities, just the Masonic fraternity—is in the aggregate in excess of $400 million by our charitable endeavors.

My colleague, Mr. Clausen, to my immediate right, has prepared a written presentation and he has an exhibit attached to it—a slice of the pie, if you will, the Masonic charitable pie. What are the Masonic charities, and which branches of Masonry contribute to them.

You will note that my corporation, Shriners Hospital for Crippled Children, is shown there in 1975 as contributing approximately $44 million through our philanthropy, Shriners Hospitals for Crippled Children.

This year, I wish to advise you that my fraternal corporation raises money and gives it away free, without regard to race, color, creed or sect, in the form of medical services to crippled children in the aggregate amount of $50 million.

Now, when Treasury tells me that the public cannot afford to give up $5 to $10 million annually in lost revenue for the sake of getting from my hospital corporation $50 million, I say someone is pretty short sighted. Our hospital system gives away its medical services. You cannot buy them. The point is, we give them away to those in need. Those in need are those who cannot financially afford the best possible medical care for the cure and treatment of these crippled children.

You know, a wealthy man cannot buy the services that our hospitals provide, no one can; not an insurance company, not a government. We do not accept a dime from anyone in any capacity—from the government—from an insurance company, or from the family of a child. We give away our medical services. We will not accept government money, subsidies, if you will. A tax deduction is not a subsidy.

This bill would allow only a deduction for a contribution to the construction and maintenance of a building which houses our fraternity. The point is that our philanthropy cannot really exist without the support of our fraternity. Our fraternity is in every State in the Union. We have 21 hospitals, 2 in Canada; 19 in the United States. But in every State in the Union our Shrine Temples exist. We have 170 in the United States of America.

The buildings, the Masonic buildings of the Masonic fraternity are getting older. There has been a steady decline in membership, I would remind you, in the Masonic fraternity over the last several years, I think some 50,000 net deficit in membership last year. For the first year in 38 years the Shrine last year had a net loss in membership.

I respectfully suggest that the goal of our fraternity, its reason for being, is the charitable endeavors which support our Colorado corporation, Shriners Hospitals for Crippled Children. I respectfully suggest, it is in the public interest to see that this charity stays in existence; to see that it is well supported by our fraternity and that it is healthy because we have treated hundreds of thousands of children since 1922 and 75 percent of the orthopedic surgeons in this Nation were trained in our hospitals. I respectfully submit, our fraternity does serve a substantial public purpose.

[The prepared statement follows:]

Statement of the Imperial Council, Ancient Arabic Order of the Nobles of the Mystic Shrine of North America ("The Shriners"), Tampa, Fla.

My name is Edward G. Maag, and I serve as General Counsel of the Imperial Council of the Ancient Arabic Order of the Nobles of the Mystic Shrine for North America, commonly referred to as the Shrine, a non-profit and tax exempt fraternal organization described under Section 501(c) (10) of the Internal Revenue Code. I have with me our Tax Counsel, William J. Lehrfeld, of Washington, D.C.

There are approximately one million (1,000,000) Shriners, the vast majority of whom are Americans. Since 1935, the Imperial Council A.A.O.N.M.S. and its one hundred eighty-one (181) Shrine Temples, chartered by the Imperial Council, have been granted a group tax exempt status by the Internal Revenue Service. The objects and purposes of the Imperial Council A.A.O.N.M.S. reflect such attitudes as faith in God, man's relationship with his brother and philanthropy.

The Shrine has long been characterized for the color and pageantry of its parades, its marching Uniformed Units, its bands and its clowns. It has been equally characterized for its fundraising activities (circuses and sporting events) which individual Shrine Temples sponsor to raise funds for what many persons have aptly described as "The World's Greatest Philanthropy"—Shriners Hospitals for Crippled Children.

Today contributions to the Shrine fraternal order, and contributions to Shriners Hospitals are deductible for federal income, gift and estate tax purposes, under IRC Secs. 170(c) (4) and 170(c) (2), respectively if the gift is made for exclusively charitable purposes. H.R. 4175 would treat as an exclusively charitable purpose the construction or maintenance of the fraternal order's principal building which houses the order's activities.

Every Shriner is annually assessed a hospital assessment by the Shrine to support its charitable endeavor. In addition, whenever our Shrine Units parade, they attempt to call attention to our philanthropy. Our fundraising events are known throughout this great land as a means by which monies are raised to continue this support of our charity. These monies also substantially assist our Shrine Temples in defraying the expenses of bringing many crippled and burned children, along with their parents, to our twenty-one (21) hospitals for treatment since the charter and regulations of Shriners Hospitals does not permit such expenditure of funds. Likewise, our Shrine Temples meet certain charitable hospitalization needs and expenses of our out-patients which sometimes goes beyond orthopedic and burn care.

It has been vividly demonstrated over the years that the "Shrine" is a body of men dedicated to a singular charitable purpose; and this charitable purpose is one which all Shriners freely donate of their time, energy and money. The charitable purpose is, plainly stated, needy children.

Since 1922, the Shrine has provided totally free care to children afflicted with orthopedic problems. Over this period of time, about one-fourth (¼) of the orthopedists in the nation have been Shrine-trained. In 1962, after the military leaders of this nation interested the Shrine in what they felt was one of the greatest unmet needs—the care and treatment of badly burned children, we dedicated three (3) hospitals completely to the care of severe thermal injuries in children. The present annual operating expense of Shriners Hospitals for Crippled Children is approximately fifty million dollars ($50,000,000.00). These hospitals have cured or materially helped more than two hundred thousand (200,000) children.

All of our care is paid for by the hospital corporation's endowment, by Shrine fundraising events and by the Shrine assessments on members of the Order. We have taken no fees, insurance or government funds.

All of these worthwhile activities sponsored by the Shrine in the interest of public welfare would be greatly enhanced if the Shrine and other charitable-minded fraternal organizations are permitted to have donors receive a charitable contribution deduction for gifts and contributions they make to the cost or maintenance of exempt fraternal organization buildings, the principal purpose of which is to house such organization's fraternal and charitable activities. We believe that the revenue lost to the Government for allowing such a charitable contribution deduction to donors is nominal. The net gain to the Government, and to the public it serves, is in enhancing the private sector's capability to further serve the public.

On behalf of our one million (1,000,000) Shrine members, we wish to wholeheartedly support the enactment of H.R. 4175 so that all of our charitable activities can continue through the voluntary assistance of Shriners.

Thank you for giving us this opportunity to testify.

Mr. Rostenkowski. Thank you, Mr. Maag.

Mr. Clausen. Shall I proceed as next in order?

Mr. Rostenkowski. Mr. Clausen!

STATEMENT OF HENRY C. CLAUSEN, SOVEREIGN GRAND COMMANDER OF THE SCOTTISH RITE SUPREME COUNCIL, ANCIENT AND ACCEPTED SCOTTISH RITE OF FREE MASONRY

Mr. Clausen. My name is Henry C. Clausen. I am now and have been since 1969 the sovereign grand commander of the Scottish Rite Supreme Council, Southern or Mother Jurisdiction of the World. Other than that, my Masonic experience has been as master of my own lodge in San Francisco and as grand master of the Grand Lodge of California.

May I make an observation at the outset in response to the presentation of the Treasury Department. The use of the words "fraternal organization"—fraternal organization should be distinguished in that this bill would give a benefit to those that meet the test of 501(c)(10). In other words, only a 501(c)(10) organization would be given the benefit of the bill. A 501(c)(10) organization was set up in 1969 to cover the particular type that we feel should be encouraged by being able to make these renovations.

My jurisdiction has 650,000 members. We are in some 220 cities of the United States in the 35 States of the Nation that are our jurisdiction; the Northern Masonic Jurisdiction of the Scottish Rite has 500,000. So, I speak in effect for 1,150,000 Scottish Rite men and their families.

We derive our membership from master Masons who have received their degrees in what we call a symbolic lodge. The various grand lodges in some 50 States of the Union govern those lodges. We select our men of good character, good morals, good reputation, belief in God, immortality of the soul, and subject to unanimous favorable ballot. That number is at least 3.5 million in the United States.

The problem behind this legislation arises in that the meeting places of these Masonic lodges and of the Scottish Rite and similar organizations in many cases have become dilapidated, are in unsafe places in cities, and they require removal, renovations, improvements, and rehabilitation. Experience has shown that if the expenses for these removals and renovations were tax deductible, members would make personal contributions to pay them, and by doing so the organization itself would be encouraged to make the charitable contributions it does, which must be done out of necessity to survive.

For example, all temples of which I speak are engaged in charitable activities, and in some there are the facilities for the charities. For example, our organization does a great deal for children afflicted with aphasia. The program is in process in Alabama, California, Colorado, Florida, Georgia, Kansas, Mississippi, North Carolina, Tennessee, Texas, Virginia, Oklahoma, Nebraska.

This subject of rehabilitation might seem odd when we contribute toward charity without regard to race, color or creed, or Masonic membership, more than $1 million every day. Those funds are usually earmarked for charitable purposes. They are not to be touched to do the building, the renovating, the fixing and the improving required, all of which should be done and must be done to maintain membership.

So, this legislation would help us carry on the charitable activities because if the membership declines so, correspondingly, do our charitable contributions.

Now, this pie I have attached to my statement, which I ask to be included in the record, shows the contributions by percentages for 1 year. Experience has shown when a local lodge is removed from an unsafe to a secure place in the city, or if you fix up the kitchen or put in a carpet, or paint the place, you attract members. If you do not, you lose members. If you do not maintain the lodge facilities you kill the goose that laid the golden egg because the members supply the funds.

The result, throughout the Nation, is acute. I want to point out, please, the legislative history of 501(c)(10) under which our organization and the other organizations that would benefit must qualify, must meet the test.

That legislative history was part of the tax reform law of 1969. Contrary to what the Treasury Department said, the significance of the distinction should be borne in mind because this is a direct quote from the legislative history of 501(c)(10). This Congress said that:

> A new category of exemption for fraternal beneficiary associations is set forth which applies to fraternal organizations operating under the Lodge system where the fraternal activities are exclusively religious, charitable, or educational in nature and no insurance is provided for the members.

The last part of my statement is the distinction. Ours do not provide insurance.

The committee went on to say, "The committee believes that it is appropriate to provide a separate exempt category for those fraternal beneficiary associations" and then in parenthesis the committee put, "such as the Masons" end of parenthesis, which do not provide insurance for their members.

The committee says, "This more properly describes the different types of fraternal associations."

Now, in addition to that legislative history I point out that the Congress has recognized the character of our particular Scottish Rite organization by granting to my supreme council an exemption with respect to real estate for what we call "The House of the Temple" here in Washington on 16th Street and "R".

So, the proposed legislation would benefit all organizations of 501 (c)(10) whether they be the Knights of Columbus, the Masons, the Oddfellows, Elks, Sons of Italy, Knights of Phythias, or any such similar organization.

[The prepared statement follows:]

STATEMENT OF HENRY C. CLAUSEN, SOVEREIGN GRAND COMMANDER, THE MOTHER SUPREME COUNCIL, WASHINGTON, D.C.

My name is Henry C. Clausen. I am now, and have been since 1969, the Sovereign Grand Commander of the Scottish Rite Supreme Council, Southern or Mother Jurisdiction of the World. Prior to that, my Masonic experience has been as Master of my own Lodge in San Francisco and as Grand Master of the Grand Lodge in California.

The total membership of the Southern Jurisdiction, or Mother Jurisdiction of the World, is 650,000 plus, with local organizations in some 220 cities throughout the United States, in the 35 States of our Jurisdiction.

In addition to speaking for my organization, I, this morning, speak for the Northern Masonic Jurisdiction at the request of the Sovereign Grand Commander, Stanley Maxwell. They have a total combined membership of 500,000 so I am speaking for some 1,150,000 men and their families.

The membership of the Scottish Rite is derived from Master Masons who have received three degrees in what we call a Symbolic Lodge. The various Grand Lodges in each of the 50 States of our Nation govern these lodges. We select men of good character, good morals, good reputation, belief in God, immortality of the human soul, and subject to unanimous favorable ballot. Those number today about 3.5 million in the United States.

The problem behind this legislation is that the meeting places of these Masonic Lodges and the Scottish Rite and other similar organizations, have become in many cases, dilapidated, are in unsafe places of cities, requiring removal, renovations, improvements, and rehabilitation. Experience has shown that if the expenses are tax deductible the members will make personal contributions to pay these.

All our Temples are engaged in charitable activities and in some we have the facilities, for example, to carry on our program for children afflicted with aphasia. in progress in the following States: Alabama, California, Colorado, Florida.

Georgia, Kansas, Mississippi, North Carolina, Tennessee, Texas, Virginia, Oklahoma and Nebraska.

The subject of rehabilitation might seem sort of odd when it is borne in mind that these combined Masonic organizations today contribute towards charity, many without regard to race, color, creed or Masonic membership, more than $1 million every day. Those funds are usually earmarked for charitable purposes. They may not be touched to do the building, the renovating, the fixing and the improving required, but all of which is necessary to maintain membership.

This legislation would help us carry on our charitable activities because if our membership declines then so correspondingly do our charitable contributions. Our capacity depends upon our membership. There is attached to "Pie," that shows our daily charitable contributions.

Real experience has shown that where you remove a local lodge in some town from an unsafe to a more secure location, or where you fix up the kitchen and put in new carpet and paint the place, you attract members and if you do not do that, you lose members. If you do not maintain the lodge facilities you kill the goose that laid the golden egg because the members supply the funds for the philanthropic purposes.

The result is, Mr. Chairman and Committee, that an acute situation exists with regard to need for these renovations.

We point out that our organization itself is solely and exclusively educational, charitable and religious, and that the Congress already has so found. In other words, the Congress has so found in the legislation for 501(c)(10) IRC under which our organization does qualify for an income tax exemption. The legislative history of the Joint Committee of the Congress held that it was appropriate to provide a separate, exempt category for those fraternal associations, such as the Masons, which do not provide insurance for their members. That is we. We refer, for example to the Legislative history of Section 501(c)(10) of the Tax Reform Law of 1969 that shows the Congress recognized our special situation and consequent rights. It reads in part:

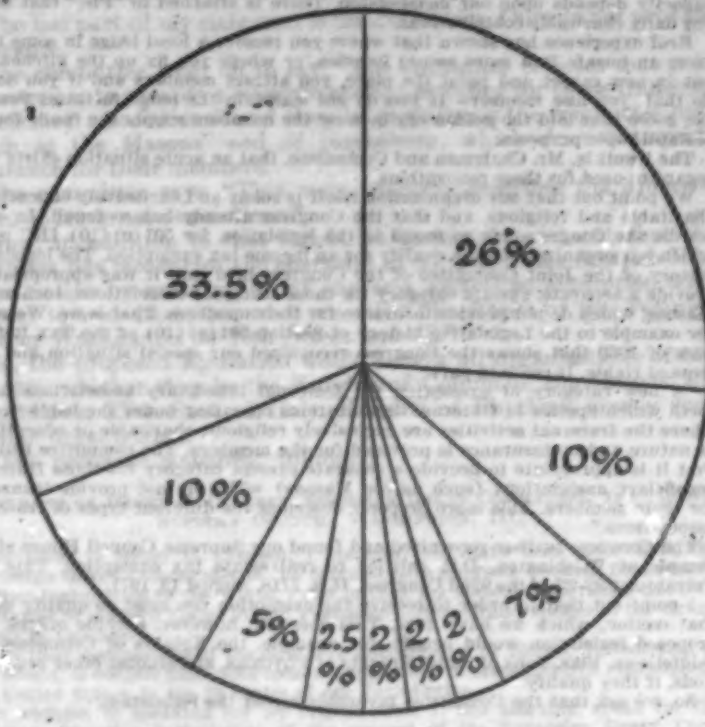
"A new category of exemption for fraternal beneficiary associations is set forth which applies to fraternal organizations operating under the lodge system where the fraternal activities are exclusively religious, charitable or educational in nature and no insurance is provided for the members. The committee believes that it is appropriate to provide a separate exempt category for those fraternal beneficiary associations (such as the Masons) which do not provide insurance for their members. This more properly describes the different types of fraternal associations."

The Congress further recognized and found our Supreme Council House of the Temple at Washington, D.C. entitled to real estate tax exemption. This was Private Act 92–23 of the 92nd Congress, H.R. 7718, August 13, 1971.

I point out that in order to receive the exemption you must so qualify under that section, which we have done. This does not, however, exclude others. The proposed legislation would benefit, for example, the Knights of Columbus, the Oddfellows, Elks, Sons of Italy, Knights of Phythias, and similar other organizations, if they qualify.

So, we ask that the Committee favorably report the legislation.

Masonic Charitable Contributions 1975



33.5% - Local "Lodge" Benevolences (50 States), $150,000,000

26% - Masonic Homes and Hospitals, $113,670,000

10% - Masonic Scholarship Programs, $44,800,000

10% - Shrine Hospitals for Crippled and Burned Children, $42,3000,

7% - Masonic Health Research Projects, $29,410,000

5% - Sundry Masonic Benevolent Programs, $22,770,000

2.5% - National Public Service Projects, $11,450,000

2% - Masonic Relief, $7,215,000

2% - Masonic Youth Projects and Eye Foundation, $5,2000,000

2% - Scottish Rite Masonic Museum and Library, $7,680.000

Mr. Rostenkowski. Thank you, Mr. Clausen. Mr. Kameil, do you have a statement?

STATEMENT OF MAX L. KAMEIL, COMMANDER IN CHIEF, LONG ISLAND SCOTTISH RITE SUPREME COUNCIL, ANCIENT AND ACCEPTED SCOTTISH RITE OF FREE MASONRY

Mr. Kameil. Mr. Chairman, my name is Max L. Kameil, I am the commander in chief of Long Island Rite Supreme Council.

I can just state briefly that I have traveled throughout the State of New York and I visited practically every lodge in the State. The condition of these buildings is very dilapidated; they are old, some of them are 50, 60, and 70 years old and nothing has been done to them; they need repairs. Some of them have to be moved to safer areas.

We are engaged, of course, in and every lodge does charitable work through the Grand Lodge and also through Scottish Rite and the Shrine. I must state that we have a Masonic medical research laboratory in Utica; we support children's camps, and, of course, the Shriners Hospitals for Crippled Children, and the Scottish Rite Benevolent, which is on schizophrenia.

I wish to state to this committee that we have for generations on an annual basis in the summer a ball game with the Knights of Columbus and the proceeds are for the Demolay 50 percent and the Catholic Youth Organization.

If we cannot provide proper housing for our membership, we keep losing them continuously, and if we lose them, we lose our charitable income.

I respectfully pray, Mr. Chairman, that you and your committee recommend favorable action on this bill.

Mr. Rostenkowski. Thank you. Are there any questions?

Mr. Duncan. I have a question, Mr. Chairman.

Mr. Rostenkowski. Mr. Duncan?

Mr. Duncan. Is it your judgment that H.R. 4175 would help your charitable efforts?

Mr. Clausen. There is no question about it because it generates the charities. In other words, the facility must be in operation to generate the charities. As has been pointed out, the facilities need repairs, relocation, renovation. The funds would be made available if we could say to the members that a tax deduction would be allowable for that purpose.

Mr. Duncan. Mr. Maag, in your statement you indicated that it would affect not only the Masonic fraternity but the Elks?

Mr. Clausen. The Knights of Columbus.

Mr. Duncan. The Fraternal Order of Police.

Mr. Clausen. All similar 501(c)(10) organizations.

Mr. Duncan. If this is not enacted, what effect do you think it is going to have upon organizations such as the Masonic fraternity?

Mr. Clausen. What was that?

Mr. Duncan. If it is not enacted, if 4175 is not enacted, what effect is it going to have?

Mr. **Clausen.** If it is not enacted, it will make possible that we will die on the vine.

Mr. **Duncan.** Have you been having a decrease in membership?

Mr. **Clausen.** Yes, that is exactly the point. If the facilities are renovated, if the kitchens are painted, new carpets put in, the place made to look decent, members are attracted. In many cases the lodge facilities at the present time are in portions of the cities that are unsafe. Members are reluctant to attend. So, it is necessary to move to another part of the city.

Mr. **Duncan.** Thank you very much for your statements. Thank you, Mr. Chairman.

Mr. **Rostenkowski.** Thank you, gentlemen.

The Chair would like to welcome a distinguished Member of the Congress joining us this morning. Mr. Clarence Brown of Ohio. We are very happy to have you with us this morning.

STATEMENT OF HON. CLARENCE J. BROWN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OHIO, ACCOMPANIED BY J. PAUL McNAMARA AND JAY MORRIS, COUNSELS

Mr. **Brown.** Mr. Chairman, thank you very much. This has been "testimony interuptus" this morning with all the bells. I am sorry it has occurred that way.

I would like to introduce the panel. On my left is Mr. J. Paul McNamara—the author of Mrs. June W. Fenton's will—of the law offices of McNamara and McNamara in Columbus, Ohio; and Mr. Jay Morris of the Washington office of Vorys, Sater, Seymour & Pease, a Columbus law firm, the largest law firm in the State capital. These gentlemen are my technical support on the legislation which I am asking you to consider this morning because, as you know, I am not an attorney, just an humble newspaperman who has turned himself to public service.

Mr. Chairman, I thank you for this opportunity to appear before the Subcommittee on Select Revenue Measures this morning. I appreciate your interest in and attention to my legislation, H.R. 7220, which will prevent the loss of many thousands of dollars to numerous charities by extending until December 31, 1980, the period to amend governing instruments—or wills, as those of us who are laymen would call them—establishing charitable remainder trusts and charitable lead trusts.

As you well know, because this subcommittee has had to return to the issue several times in the past decade, the Tax Reform Act of 1969 imposed new requirements which must be satisfied by a charitable remainder trust, in order to qualify for an estate tax deduction.

These new requirements represent a sharp departure from the old ground rules establishing such charitable trusts. Therefore, Congress delayed the effective date of the provisions to permit the legal profession a period of time to digest the new requirements.

When the Internal Revenue Service later issued the regulations to carry out the requirements, it granted an additional period of transition—recognizing the complex situation created by the changes.

Since the expiration of that deadline on January 1, 1973, the Congress has three times—in 1974, 1976, and 1978—extended the transitional period during which such wills could be amended to bring them into conformity with the 1969 act.

I will not belabor the subcommittee with the various dates and conditions of these extensions. I will only point out that the most recent extension was provided under the Revenue Act of 1978, which extended until December 31, 1978, the time to amend—or to commence judicial proceedings to amend—instruments establishing charitable lead trusts and charitable remainder trusts which were executed before December 31, 1977.

As you know, Mr. Chairman, my legislation would provide an additional time extension, until December 31, 1980, for amending instruments executed before December 31, 1977.

The need for this additional extension was brought to my attention by the attorneys associated with the estate of Mrs. Irene W. Fenton, formerly of Bellefontaine, Ohio, located in my congressional district.

Mrs. Fenton died on December 2, 1978, and her will was admitted to probate in January, 1979. Mrs. Fenton's will makes clear her intention to establish a charitable remainder unitrust in conformance with the Tax Reform Act of 1969. In fact, her will states:

> * * * the trusts created by Item Fifth of this Will are intended to qualify as charitable remainder unitrusts as defined in Section 664(d)(2) of the Internal Revenue Code of 1954 as amended. Therefore, any power herein granted to my Trustees that may detract or impair the qualifications of the aforesaid trusts as defined in Section 664(d)(2) of the Internal Revenue Code of 1954, is null and void.

Nonetheless, when petitioned for a ruling on Mrs. Fenton's will, the Internal Revenue Service took the position that for highly technical reasons the Fenton will does not create a qualifying charitable remainder trust.

The technical defect in the Fenton will, according to IRS, is that the first trust pours-over 20 percent of the principal to a new or second trust. The Fenton trust would have qualified if there had been either (1) only one trust from the beginning, with 80 percent paid out on one date and 20 percent on a later date, or (2) if there had been two trusts from the beginning, one trust containing 80 percent of the principal and the other trust containing 20 percent of the principal.

Because the position of IRS remains firm in this matter, it is necessary to amend the Fenton will. Unfortunately, the last deadline for amending such wills expired less than a month before the Fenton will reached probate.

Therefore, in order to amend the Fenton will, an additional extension of the conformity period is necessary, as provided in H.R. 7220.

I would like to point out that the Fenton estate was appraised at nearly $3.4 million, and it has been estimated that failure of the estate to qualify as a charitable remainder trust will result in the loss of approximately $500,000 in additional taxes to the charities selected by Mrs. Fenton as her beneficiaries. These beneficiaries are Overlook House, a retirement home in Cleveland, Ohio; Glenmont Home for Christian Scientists, Inc., in Columbus, Ohio; the Leelanau School in

Glenn Arbor, Michigan; and the Principia Corp. in St. Louis, Mo., which operates Principia College.

Mr. Chairman, I again thank you and the members of the subcommittee for the time and attention you have devoted to this issue. At this point I would be happy to address any questions you may have on the bill, with the help of the two gentlemen I introduced to you previously.

Mr. ROSTENKOWSKI. Thank you, Mr. Brown, for a very informative statement. Are there any questions?

Mr. DUNCAN. I have no questions, I want to thank my colleague.

Mr. ROSTENKOWSKI. Thank you very much.

Mr. BROWN. Thank you, Mr. Chairman.

Mr. ROSTENKOWSKI. Mr. Dowden? Welcome, Mr. Dowden, to the committee. If you will identify yourself and proceed with your testimony, the committee is ready.

STATEMENT OF C. JAMES DOWDEN, EXECUTIVE VICE PRESIDENT, COMMUNITY ASSOCIATIONS INSTITUTE, ACCOMPANIED BY DOUGLAS M. KLEINE, DIRECTOR OF PROGRAMS

Mr. DOWDEN. Thank you, Mr. Chairman.

I am James Dowden, I am the executive vice president of the Community Association Institute. I have with me Mr. Doug Kleine of our staff who is director of programs.

I have submitted a prepared statement, Mr. Chairman, and rather than go through the process, if I could just briefly summarize.

Mr. ROSTENKOWSKI. Mr. Dowden, your entire statement will be introduced into the record. If you will proceed.

Mr. DOWDEN. Thank you, Mr. Chairman.

We have had the opportunity to follow the legislation dealing with the correction of what we think is a gross inequity for condominium and homeowner associations for several years. H.R. 4511, in our opinion, is a proper act for Congress to correct that inequity, and I am appearing today at the request of our national board of trustees and the membership of the Community Association Institute to urge your support of that legislation.

Just a quick background, Mr. Chairman, on what CAI is. We are a national nonprofit membership organization of condominium and homeowner associations, and others involved in creating and operating condominium and homeowner associations.

We would like to urge your support of this legislation because we feel that the original congressional intent in the Tax Reform Act of 1976 in establishing section 528 of the code has not fully been met by the very act of the regulations and the requirements that have been imposed in this process.

I think there is a failure to understand what community associations are. They are basically homes of the middle class and middle-income families—they are not havens of the rich, nor are they tax dodges or tax scams designed to hide what the Treasury Department has described as "portfolios of assets."

There are several problems that we are encountering with section 528. It was the original congressional intent in developing that section to recognize the nonprofit, volunteer status of condominium associations; to encourage the set-aside of reserves for future capital repair and replacement of roads, roofs, and other major facilities; and to provide a simple tax procedure for treatment of the earned income of condominium associations.

The typical condominium, nationwide, has an annual budget of $75,000 to $125,000 a year. That entire income, or a substantial portion of it, is earned through monthly assessments on individual owners. From our figures, the average income of the family who is an owner of the typical condominium unit nationwide is less than $30,000 a year. The average purchase price of the typical condominium is less than $50,000, and according to the current practices of the lending industry, an individual earning $25,000 in gross income could finance the purchase of a $50,000 condominium. Clearly, the typical condominium unit owner is a middle-income wage earner. These are not havens of the rich.

The purpose of the condominium association is to maintain the property—to maintain the building, the structure, and the roadways. We should not be taxing these entities as if they were profitmaking ventures at the highest available tax rate imposed on profit organizations.

The effect of the 46-percent tax rate currently imposed on the condominium association in section 528 is to penalize the association that sets aside funds to later repair the roof, the roadway, or other facilities. As a consequence, fewer condominium associations are setting aside such funds. According to IRS figures, less than 25 percent of all associations are actually exercising the 528 option because of this penalty tax.

In the original legislation the intent was to exempt from taxation those funds that were to be used for maintenance of facilities, and to tax other income earned from outside sources. Unfortunately, as a penalty for the first exemption, a 46-percent tax rate was imposed on this outside income.

H.R. 4511 proposes to treat associations' unrelated income on the same graduated tax rate as is applied to taxable corporations. We believe that structure makes sense and that that rate is fair and equitable. Unfortunately, the Treasury position keeps changing. On the Senate side they opposed any change to the 46-percent rate. In their position to you this morning they proposed a new 30-percent rate. We are not satisfied with half of the pie.

The Treasury position continues to be one that portrays condominiums as some place where people are hiding assets and, again, as havens of the rich for some tax-avoidance scam.

Owners of condominiums have no capacity to consolidate or adjust their associations or to otherwise bring about an amalgamation of associations to cause a tax avoidance. The association cannot receive donations or contributions of what Treasury has described as "portfolio assets" because such contributions would not be tax deductible to the donor.

Section 528 currently has both an income test and an expense test that will prevent abuse. The condominium association is thus prevented from being used as a haven for the development of unrelated income or business income activities.

Moreover, it would appear from Treasury's statement that their vision of "condominium" is some luxury highrise in a resort location. In actual fact, according to the figures we have, more than 80 percent of all condominium units are in suburban locations; they are townhouse or lowrise buildings—they are not recreational properties on the ocean or in the mountains.

The 30-percent rate that the Treasury people recommended to you this morning really appears to be based on the marginal tax rates. Doug Kline went over this morning to the personnel office of the congressional staff to obtain an income tax guide. We tried to compute out the actual impact of the proposed 30-percent rate. This goes back to Treasury's conduit theory of taxing the associations in order to prevent the owners of condominiums from hiding some investment income.

At the marginal rates, an individual's adjusted, taxable income, would have to be $24,000 to $30,000 in order to hit the 31-percent rate. However, when using the standard deduction, the individual could earn up to $40,000 a year in salary and not be taxed at higher than 21 percent.

The average condominium price—repeating—nationwide this year is $50,000 a year. You can finance the purchase if you have a gross income of $25,000 a year. Based on the current tax rates, using the standard deduction, if you have a gross income of $25,000 a year you are not going to be taxed at 30 percent. As near as we can tell from the limited data we have available, the average savings balance—that is the predominant source of investment income of the typical condominium association, is in the neighborhood of $15,000 to $20,000 of investment assets. That would give us a total interest earned of $1,500 to $2,000 in taxable income to that association.

Treasury's position now, is that that income ought to be taxed at 30 percent. We believe it ought to be taxed, if at all, at the same graduated rates applied to all other corporations.

Mr. Chairman, in 1974 a series of IRS rulings determined that condominiums are profitmaking ventures. By the act of maintaining a person's home this corporation was enhancing the individual person's profit, and therefore we were forced to come before Congress and in the 1976 Tax Reform Act were successful in at least exempting a portion of those funds from tax treatment because it was pure maintenance.

We have come to live with the proposition that we ought to tax the investment income on the basis that it is an outside, unrelated business income. But we believe it ought to be taxed as any other profitmaking corporation is taxed, at the graduated rates and not at an artificial limit of 30 percent as proposed by Treasury today.

Mr. Chairman, we appreciate your hearing us this morning and hope that you will support this legislation. We are available for questions.

[The prepared statement follows:]

STATEMENT OF C. JAMES DOWDEN, EXECUTIVE VICE PRESIDENT, COMMUNITY ASSOCIATIONS INSTITUTE

Mr. Chairman and members of the committee, my name is C. James Dowden and I am Executive Vice President of the Community Associations Institute. We apologize that our President, James L. Laughlin, who was in town earlier this week, had to return to Oregon and could not be here today. I have with me today, Douglas Kleine, who is the Director of Programs of the Community Associations Institute.

CAI is a nonprofit research and educational membership organization created to help those individuals and professionals involved in creating and operating condominium and homeowner association developments. CAI was incorporated in the fall of 1973 and was staffed in September, 1974. The Institute has over 8,500 active members today, representing every aspect of the process of creating and operating condominium developments, including homeowner associations, builders and developers, property managers, professional colleagues and public officials. Our membership spreads to every section of the country with condominium activity and we currently have some twenty local chapters operating in major metropolitan areas.

CAI was created specifically to provide a neutral service organization to meet the information and technical assistance needs of increasing numbers of practitioners and owner leaders in the growing condominium and planned unit development field. Our corporate structure is such that no one segment of the industry or the consuming public dominates our decision-making or policy-making process. We are not advocates for any one interest group involved in condominiums or planned unit developments but rather are advocates for the successful process for creating and operating condominiums and homeowner associations in cluster developments.

CAI's ongoing program today is largely devoted to periodic newsletters on events of interest in the field, handbooks, special reports, other materials to guide practitioners through this process and an extensive program of workshops and national conferences to better educate those individuals involved in this process. From time to time, the Institute is involved in more direct research and contract-related activities that are intended to expand the state of the art in the condominium field. Last year, for instance, the Institute completed two research projects financed by the Department of Housing and Urban Development—one project was designed to demonstrate the feasibility of utilizing the condominium approach to provide ownership housing for lower income families, and the second project produced a manual on community associations for local public officials. However, more than 90 percent of the total financial support of the Institute is derived from member fees and charges.

I am speaking today at the direction and on behalf of the Executive Committee of the Board of Trustees of CAI.

GROWTH OF CONDOMINIUM AND HOMEOWNER ASSOCIATIONS

The number of condominium and homeowner associations had doubled since 1975. It is estimated that there are now in excess of 40,000 housing projects across the country involving the shared use or ownership of land and facilities. Each such project has an association of homeowners responsible for maintenance and repair of shared facilities and grounds.

WHAT IS A COMMUNITY ASSOCIATION?

The homeowner association in a condominium or planned unit development, referred to as a Community Association, is a nonprofit entity under state law and is organized to maintain such shared facilities as open space, streets, street lights, hallways, etc. and such services as landscape and exterior maintenance, trash collection, etc. The typical Association budget is $75–125,000 per year of which an average of $10,000–12,000 is set aside for future replacement or repair of capital items. These reserves are required by some states and are also necessary for FHA insured condominiums as well as condominiums and homeowner associations eligible for FNMA and FHLMC mortgage purchase programs.

REVIEW OF FEDERAL TAX SITUATION OF COMMUNITY ASSOCIATIONS

The Tax Reform Act of 1976 added Section 528 of the Internal Revenue Code to allow condominium and homeowner associations to establish reserves for future major repairs and replacement without the adverse tax treatment that would have resulted under earlier IRS Revenue Rulings. Most associations can also elect to be treated as taxable corporation. A few associations are tax exempt under Section 501 (c) (4) of the Code.

PURPOSE OF SECTION 528

The enactment of Section 528 was intended to recognize and deal with the unique problems of condominium and homeowners associations and their volunteer boards of directors.

Section 528 has been beneficial to those associations electing to use its provisions which protect the long-term capital reserves. We are confident that when IRS publishes final regulations, several other minor problems will be resolved. Yet most associations do not use Section 528.

PROBLEM WITH SECTION 528

The single most important problem with the provisions of Section 528 is that associations electing to come under the Section are taxed at a 46-percent rate on miscellaneous income. Miscellaneous income consists of many minor items such as revenue from the poolside vending machine, income from the coin laundry vendor or a charge for the use of the party room. But the largest component of the miscellaneous income is interest earned by associations on the long-term capital repair and replacement funds. Interest from these reserve accounts, which Congress encouraged associations to establish and maintain by enacting Section 528, is taxed under Section 528 at present at the highest corporate rate of 46 percent. As a result, only 20 to 25 percent of all associations file under Section 528.

OPTIONS PRESENTLY AVAILABLE TO ASSOCIATIONS

Corporate filing

A number of sophisticated tax theories are being used by some condominiums and homeowners associations today. The two most prevalent are the trust fund theory and the capital contributions theory. Many tax experts believe that both theories, if correctly applied, can provide a means for an association to set aside reserve funds without adverse tax consequences. The association could then file as a corporation or trust and subject net income to the graduated corporate rates. For most associations, the tax rate would be 17 percent as opposed to the 46-percent rate under Section 528. Figure 1 demonstrates the difference. Filing as a corporation has certain other advantages, such as the ability to use operating losses to offset interest income or the use of investment tax credits and the use of loss carry-forwards, all of which are denied to the association if it files under Section 528.

For most volunteer-run associations, however, these complicated and sophisticated methods cannot be used without expensive professional tax counsel, and even then associations face some risk of reversal upon audit.

Options available to associations—use of tax exempt investments

Many associations using Section 528 invest their long-term reserve funds in tax exempt municipal bonds. Bonds paying around 6 percent provide an effective income nearly equal to the interest rate on long-term certificates of Deposit. Figure 2 illustrates the difference to the association and to the U.S. Treasury of this practice.

The conduit theory

The Department of the Treasury asserts that the most correct solution to taxation of miscellaneous income of homeowners associations would be "conduit treatment" i.e., attributing the income to members of the association and taxing it at their individual marginal rates. CAI believes that the top corporate rate of 46 percent is an unrealistic surrogate for such individual marginal rates. Far from Treasury's intention that gradual corporate rates would undertake association income, CAL believes that the 17 percent corporate rate best approximates the tax rate paid by most homeowner association members.

We are told that the national median sales price for a condominium unit is about $35,000. A buyer making $17,000 per year would qualify for a mortgage on a median-priced unit with a minimal downpayment. A single person with an adjusted gross income of $17,000 pays an income tax equal to 17 percent. If the purchaser of this median-priced unit were the head of a family of four whose adjusted gross income was $17,000 the tax would be less than 10 percent. Indeed, the taxes for a family of four do not reach 17 percent until adjusted gross income exceeds $31,000. Clearly, applying the corporate rate of 17 percent to these normal situations does not result in undertaxing of association income compared to conduit treatment.

EFFECT OF ENACTMENT OF H.R. 4511

We believe that enactment of H.R. 4511 will have a positive effect on associations and their reserve funds. Many Associations currently filing as corporations will elect to use Section 528. Figure 3 illustrates the difference. Using Section 528 is simpler and less risky, and any minor advantage to filing as a corporation is offset by the cost of professional counsel in using more sophisticated and complicated techniques.

In addition, associations using Section 528 and investing in tax exempt securities are likely to switch to higher yielding, but taxable, investments if H.R. 4511 is enacted. Figure 4 shows the benefit to the association and to the U.S. Treasury.

CONCLUSION

Enactment of H.R. 4511 completes what Congress set out to do in 1976; namely, provide fair tax treatment of condominiums and homeowner associations; recognizing their nonprofit volunteer nature; encouraging setting aside of reserves and providing a special, relatively simple place for them in the Tax Code.

FIGURE 1.—*Filing form 1120 as a corporation*

Income from members	$100,000
Less reserves/capital contribution	(10,000)
Interest income	1,000
Total income	91,000
Less expenses	(90,000)
Taxable income	1,000
Tax at 17 percent	170
Less loss carry forward, credits, etc	---
After tax income to association	830

FIGURE 2.—*Filing form 1120–H a a qualified association*

Interest income from certificate of deposit	$1,000
Less specific 528 deduction	100
Taxable income	900
Tax at 46 percent rate	414
After tax income to association	586
Interest income from tax exempt municipal bond	900
Taxable income	0
Tax at 46 percent	0
After tax income to association	600

FIGURE 3.—*Difference to association and U.S. Treasury between corporate filing now and 1120–H filing after enactment of H.R. 4511*

Filing from 1120 as a corporation:	
Income from members	$100,000
Less reserves/capital contributions	(10,000)
Interest income	1,000
Total	91,000
Less expenses	90,000
Taxable income	---
Total	1,000
Tax at 17 percent	170
Minimum after tax income to association	830
Maximum revenue to U.S. Treasury	170

FIGURE 3—Continued

Filing form 1120–H as a qualified association assuming enactment of H.R. 4511:	
Interest income	$1,000
Less specific 528 deduction	100
Taxable income	900
Tax at 17 percent rate	153
After tax income to association	847
Revenue to U.S. Treasury	153

FIGURE 4.—*Comparison of after tax income to association and revenue to U.S. Treasury before and after enactment of H.R. 4511*

Before H.R. 4511: Filing form 1120–H as qualified association under present legislation:	
Interest income from tax exempt municipal bond	$600
Taxable income	0
Net after tax income to association	600
Revenue to U.S. Treasury	0
After H.R. 4511: Filing form 1120–H as a qualified association assuming enactment of H.R. 4511:	
Interest income from certificate of deposit	$1,000
Less specific 528 deduction	100
Taxable income	900
Tax at 17 percent rate	153
Net after tax income to association	847
Revenue to U.S. Treasury	153

Mr. Rostenkowski. Thank you, Mr. Dowden. Are there any questions? Mr. Stark.

Mr. Stark. I just wondered where those $50,000 condominiums were, or the ones lower than $50,000.

Mr. Dowden. You know, this gets exactly to our problem. Of course, getting the numbers on an average nationwide is always a problem. Our hangup is that when you talk to someone who is not familiar with the business, their concept of "condominium" is a highrise on the ocean, or a project on Connecticut Avenue where the unit price may be in the $100,000 or $150,000 range. In plain point of fact, if you look at the real estate section of the Post this weekend you will find that if you want to buy something for under $100,00 inside the beltway, it is likely to be a condominium, it is not going to be a single family home. If you want to buy the predominantly available new for sale home available today, it is going to be a condominium in the suburbs, and it is going to be in the $50,000 range, not in the $80,000 or $85,000 range of the single family house.

Mr. Stark. Do you include the planned unit developments?

Mr. Dowden. Yes, sir; I do.

Mr. Stark. Any type of a housing development where there has to be some kind of common ownership or common maintenance?

Mr. Dowden. In fact, we use the words "community association" as a term to apply to any automatic membership association development, and this law and this section applies to both.

Mr. Stark. Are there minimum numbers of members?

Mr. Dowden. No, sir. In fact, interestingly enough, the author of the novel "condominium" is a member of a two-unit condominium, so that they can get very small.

But Treasury seems to feel that owners can combine together to create these things after the fact, and that cannot happen. The thing is created at the time that a developer or builder puts it together. He sells it off, and once established it cannot be eliminated until all of the owners agree to eliminate it; all of them, I mean 100 percent—would have to agree to an adjustment. The reason for that, obviously is, some of the folks you are going to be hearing from later, Fannie Mae and Freddie Mac, and the various lending-related organizations will not permit such an amendment process to occur. So, some of the evenutalities that Treasury's position is premised on and intended to prevent just cannot happen. They cannot happen. We could not all go out in our neighborhood today to create such a thing.

Mr. **Stark**. Thank you.

Mr. **Rostenkowski**. Mr. Duncan?

Mr. **Duncan**. How do you control excess charges for maintenance? I know in some of the buildings the unit might be less expensive to buy, but the maintenance is higher than in the one next to it. How do you control that?

Mr. **Dowden**. Well, the process of governance of a condominium is, one unit, one vote. Each owner is a participant in that process. The initial budget is put together by the developer and his entity, but as soon as the units are past 70 percent of sales, the owners are in complete control of both the budget process and the maintenance process.

Mr. **Duncan**. Is that by operation of the law, or by contract?

Mr. **Dowden**. That is both.

Mr. **Duncan**. Some contracts are different, are they not?

Mr. **Dowden**. No, sir; if it is a condominium it is an operation of law.

Mr. **Duncan**. I would like to know; I see some variances.

Mr. **Dowden**. If it is a condominium, each State has its own statute as it applies to condominiums, and almost without exception the transfer of control occurs at some point past 75 percent of sales. That is becoming fairly uniform across the country in State law. That is further carried out through their condominium declaration.

If it is a planned unit development, as Mr. Stark has queried earlier, it is provided through contract by covenant in the declaration of C.C. & R.'s. These documents and practices are governed by the requirements of the lending-related organizations, HUD, VA, FHA, Fannie Mae, Freddie Mac. All have rather detailed requirements that insist that if normal lending agencies are being used for the purchasers purchase, that this transition occur before 100 percent of sales.

Mr. **Duncan**. Thank you. Thank you, Mr. Chairman.

Mr. **Rostenkowski**. Thank you very much, Mr. Dowden.

Mr. **Dowden**. Thank you, sir.

[The following was subsequently received:]

COMMUNITY ASSOCIATIONS INSTITUTE,
Washington, D.C., July 1, 1980.

Mr. JOHN M. MARTIN, Jr.,
Chief Counsel, House Ways and Means Committee,
Longworth Building, Washington, D.C.

DEAR MR. MARTIN: Please include the enclosed document in the record of the Subcommittee on Select Revenue Measures hearing on HR 4511, June 19th. We believe that the document demonstrates a typical condominum marketplace with over 60 percent of the project offering units for sale at $50,000 or less, and over 30 percent of the project offering units for sale at $30,000 or less.

Thank you for your consideration.

Sincerely yours,

DOUGLAS M. KLEINE,
Director of Programs.

Enclosure is retained in the subcommittee files.

Mr. ROSTENKOWSKI. Mr. Cohen, Mr. Seidman?

Mr. Seidman, would you identify yourself and proceed with your testimony.

STATEMENT OF P. K. SEIDMAN, ON BEHALF OF ESTATE OF SYLVIA S. BURING, ACCOMPANIED BY SHELDON S. COHEN, AND NORMAN L. SCHWARTZ, COUNSELS

Mr. SEIDMAN. Mr. Chairman, my name is P. K. Seidman. I am a C.P.A. I reside in Memphis, Tenn.

At my left is Hon. Sheldon Cohen, and on my right one of his partners, Norman Schwartz, who act as counsel to me in this matter.

Mr. Chairman, I also want to take this opportunity to thank you and express my appreciation for allowing us to be here this morning and present the information that we will before this committee in connection with H.R. 4544.

I have a formal statement prepared which I believe the committee has, and I request that it be made part of the record.

Mr. ROSTENKOWSKI. Your entire statement, Mr. Seidman, will be included in the record. You may proceed.

Mr. SEIDMAN. Thank you, sir.

I see no reason to go through redundancy and repeating all of the statement, the formal statement; and with your permission I would like to just hit the summary and highlights of it, and then attempt to field whatever questions you and the committee may have.

The existing estate tax rules, as you know, permit a choice for the valuation date of the property of a decedent. The choice is (a) value as of date of death, or (b) the value as of 6 months after the date of death.

This choice avoids the harsh and unfair result when property declines severely in value shortly after death. It was made part of the Internal Revenue Code initially for the protection of the heirs of any estate.

However, if the estate tax return is filed unavoidably just 1 day late, existing law disallows the alternate valuation date election and requires property to be valued at the date of death.

This loss of the election is now automatic and applies even if there is an unavoidable, reasonable cause for the late filing of the return. There are other and adequate penalties for late filing. Moreover, those other penalties may be excused if there is "reasonable cause" for the late filing.

Now, we have found that there is general agreement by the Treasury and the congressional staff that the existing rule regarding this alternate valuation date election adds up to an unfair and unintended result, and that it should be changed.

The proposed new rule restores equity and would merely permit the alternate valuation date election to be made on the first estate tax return which is filed with the Internal Revenue Service, even if it is not filed on time. It would not change the property valuation dates of the present law or have any other effect on the determination of the assets or the estate tax liability.

The proposed new rule would be applicable to all estates which have not yet filed returns, and to estates which have filed returns but which are still open under the statute of limitation. This does not create a significant administrative problem for Treasury.

This bill and its effective date provisions would not result in any unwarranted relief of any estate; it would merely provide the original congressional intended results to estates which would otherwise be unfairly penalized.

Without H.R. 4544, the heirs of the estate which I represent, and some of whom are minors, may be stripped of a substantial part of the decedent's distributable estate—only because 5 weeks prior to the date that the estate return was due, emergency heart surgery fell the only person with knowledge of the details and late filing resulted and delayed the estate application of the alternate valuation.

Now, we believe that H.R. 4544 makes for desirable legislation and constitutes good tax policy. It does not constitute a loophole and it does have universal agreement for amendment of the code. It serves to proclaim the original congressional intent to protect the heirs and does not provide unwarranted relief. It eliminates a harsh penalty in circumstances where none was ever intended. It does not involve new elections for any estate and does not jeopardize the Government's interest at all.

And so, Mr. Chairman, we hope that the committee will give favorable approval to H.R. 4544. Thank you, sir.

[The prepared statement follows:]

STATEMENT OF P. K. SEIDMAN

SUMMARY OF PRINCIPAL POINTS

1. Existing estate tax rules permit a choice for the valuation date of the property of a decedent: (a) value as of the date of death, or (b) value as of six months after the date of death.

2. This choice avoids a harsh and unfair result when property declines severely in value shortly after death.

3. However, if the estate tax return is filed just one day late, existing law disallows the alternate valuation date election, and requires property to be valued as of the date of death.

4. This loss of the election is automatic, and applies even if there is unavoidable reasonable cause for the late filing of the return.

5. There are other adequate penalties for late filing. Moreover, these other penalties may be excused if there is "reasonable cause" for the late filing.

6. We have found there is general agreement that the existing rule regarding the alternate valuation date election provides an unfair and unintended result, and that it should be changed.

7. The proposed new rule would merely permit the alternate valuation date election to be made on the first estate tax return which is filed with the Internal Revenue Service, even if it is not filed on time. It would not change the property valuation dates of the present law, or have any other effect on the determination of the estate tax liability.

8. The proposed new rule would be applicable to all estates which have not yet filed returns and to estates which have filed returns but which are still open under the statute of limitations.

9. This bill and its effective date provisions would not result in any unwarranted relief to any estate. It would merely provide the intended result to estates which would otherwise be unfairly penalized.

STATEMENT

My name is P. K. Seidman, a certified public accountant from Memphis, Tennessee. My testimony today relates to the provisions of H.R. 4544. Enactment of this legislation would remove an inequity in the Internal Revenue Code relating to the valuation of property for estate tax purposes. I would like to explain the effect of this Bill and give the reasons that I urge its passage.

Generally, under the estate tax rules, the estate tax is based upon the value of the decedent's property at the date of death. For many years, however, the law has allowed an estate to use an alternate valuation date. Thus, under current law, an estate may pay the estate tax based upon (a) the value of all of the property in the estate on the date of death or, (b) the value of the property on the day exactly six months after the date of death. This choice of dates for the valuation of the property avoids a harsh result in a case in which there is an abrupt decline in the value of the property shortly after the date of death.

H.R. 4544 would remedy a serious problem with the existing law. For some reason which we have been unable to ascertain, present law provides that the alternate valuation date may be used only if the estate elects such method on a timely filed estate tax return. Thus, if the estate tax return is only one day late, and even if the delay is due to reasonable cause, the estate may not use the alternate valuation date.

This result is incongruous and inequitable. There is a specific penalty provided by law for the late filing of an estate tax return. This specific penalty does not apply, however, if there is "reasonable cause" for the late filing. If the specified late filing penalty may be excused for reasonable cause, there certainly is no reason to impose what may be a much harsher "penalty"—the loss of the alternate valuation date—and make that penalty applicable regardless of the existence of reasonable cause.

To my knowledge, there is general agreement on the part of the Treasury and the Congressional Staff that the provisions of existing law provide an unintended result and should be corrected. Thus, everyone agrees that existing law is unfair, and that the alternate valuation date election should be available even if, for some reason, an estate tax return is filed late. The only remaining question relates to the proposed effective date for this change in law.

As it is proposed, H.R. 4544 would remove the inequitable effect of present law in those cases in which estate tax returns have not yet been filed, as well as those cases where estate tax returns have been filed late, but where the tax liability of the estate has not been finally determined. Thus, the adoption of H.R. 4544 would eliminate the harsh penalty otherwise imposed by existing law in the circumstances involved in the Estate of Sylvia Buring, with which I am personally familiar.

Sylvia Buring died November 24, 1972. At the time of her death, Mrs. Buring owned a substantial amount of stock of a New York Stock Exchange Company, and this was the most significant asset of the estate. The value of this stock declined almost 50 percent during the six months after the date of death. This is exactly the situation to which the alternate valuation date is intended to apply.

Unfortunately, the estate tax return was filed late due to the sudden illness of one of the co-executors, and the resulting inability of the other co-executor to file a tax return within the prescribed time. There is no dispute that the failure to file the return on time was due to reasonable cause, and the Internal Revenue Service agreed that no late filing penalty was appropriate. If the alternate valuation date election cannot be made by the Estate of Sylvia Buring, there would be a substantial unwarranted increase in its estate tax liability.

The alternate valuation date is intended to and should apply if a decedent's property has severely decreased in value, even if, for some reason, the return is filed late. This is particularly true in cases like the Estate of Sylvia Buring which would otherwise be penalized solely as a result of the unfortunate physical incapacity of one of the executors.

H.R. 4544 would benefit all those in circumstances similar to the Estate of Sylvia Buring. It would eliminate an unintended penalty in circumstances where no penalty is appropriate, and where the statute of limitations has not et expired.

I know that your Committee will consider carefully the substance as well as the effective date of H.R. 4544. In urging that you extend the effect of this ameliorative change in the law to situations like those of the Estate of Sylvia Buring, I believe that I am consistent with the general policy adopted by this Committee—changes in existing law which remove unintended inequity are made applicable to all cases which are open under the statute of limitations. I believe that this policy should apply in the case of H.R. 4544.

The Treasury has suggested that, in order to be fair, the presently drafted transition provisions of the Bill should apply to a broader group of estates than merely those estates which indicated the alternate valuation date election on the first return filed. We have no objection, of course, to a broader transitional rule in order to be fair to all estates in similar circumstances. Moreover, we believe that any hypothetical administrative problems can be solved without great burdens.

It is important to bear in mind that the result of H.R. 4544 is merely to extend relief to a limited number of cases which would otherwise be subjected to an unwarranted penalty. This legislation does not open any loophole or provide relief in cases in which relief is unwarranted. The value of property in an estate is fixed on the date of death and on the date six months later. No planning is involved and now new elections of the alternate valuation date or other administrative problems would result.

In summary, I believe this legislation is good legislation and good tax policy. It would have the salutary effect of providing the originally intended tax result to the estates which would otherwise be penalized improperly.

Thank you very much.

Mr. ROSTENKOWSKI. Thank you, Mr. Seidman. Mr. Stark?

Mr. STARK. How much tax difference is involved in this, Mr. Seidman?

Mr. SEIDMAN. There is a proposed deficiency as a result of imposing this harsh penalty of approximately $600,000.

Mr. STARK. Just as a matter of curiosity, you can pick a date to value an estate either at the time of death, or 1 year later?

Mr. SEIDMAN. Six months later.

Mr. STARK. Six months, that is the most leeway you get.

Mr. SEIDMAN. Yes, sir.

Mr. STARK. Could I ask if there was anything unusual in changing the valuation so dramatically between the 6-month period?

Mr. SEIDMAN. Well, in the 6-month period there was a decided drop of the predominant assets in the estate, it consisted of a listed stock, and it dropped from 44 down to almost—at the 6-month date it was 20, or 22. It kept right on dropping until it reached about 4⅝, or 5, and has not yet rebounded even today.

Mr. STARK. I am sure I owned it. [Laughter.]

Thank you very much.

Mr. ROSTENKOWSKI. Thank you, Mr. Seidman.

Mr. SEIDMAN. Thank you.

Mr. ROSTENKOWSKI. Mr. Myers, Mr. Lehrfeld? Welcome to the committee, gentlemen. Identify yourself and proceed.

STATEMENT OF WILLIAM J. LEHRFELD, TAX COUNSEL, SHRINERS HOSPITALS FOR CRIPPLED CHILDREN, TAMPA, FLA.

Mr. LEHRFELD. Thank you, Mr. Chairman. My name is William Lehrfeld and I serve as tax counsel for Shriners Hospitals for Crippled Children. Mr. Myers is tax counsel for the American Council on Education. We are here in support of H.R. 7220, dealing with the reformation of charitable remainders and we will be very brief.

I think the only point that we want to make at the outset is that the committee has probably heard our testimony in 1974. They took our testimony in 1976 and 1978 and will hear it again today. This proposal is a continuous renewal of support or an expression, by the committee of the desirability to have the opportunity to rewrite unqualified charitable remainder trusts. It will assist charities that otherwise would lose funds because the persons who wrote the remainder trust into the will were not sufficiently familiar with the extraordinarily complex rules governing gifts for charitable remainders to do it right.

We are simply one charity. Mr. Myers represents the colleges of the United States. I do not believe that there is a major charitable institution in the United States that has not, since 1969, experienced the problems of unqualified charitable transfers. All the provision (H.R. 7220) will do is permit the heirs, the executor, and the charity to agree to the proper form for the trust instrument and thereafter obtain the income, estate, or gift tax deduction, whichever would have been lost due to the improper format.

As you saw from the Treasury Department's testimony on the last page, they favor not simply the continuation on a 2-year basis of this type of legislation, but some permanent solution to the problems created by unqualified charitable transfers. We do too, and we are earnestly hopeful that the committee and the 97th Congress will give due consideration to a form of permanent charitable remainder relief which we hope will be available sometime within the next 6 months.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF SHRINERS HOSPITALS FOR CRIPPLED CHILDREN, TAMPA, FLA., BY WILLIAM J. LEHRFELD, COUNSEL

Under the present regime of our tax laws, deferred giving to charity is discouraged. Donors interested in making gifts of future interests in property are faced with complex rules dealing with, primarily, gifts to charitable remainder trusts. Deferred giving is a means by which a donor, with his or her spouse, may make a currently deductible gift to charity of a remainder interest in property and retain the use of the property (such as a residence or farm) or the income from the property for their lifetimes. At the death of the income beneficiary, the property often passes free of further trust to the charity. In 1969, Congress misperceived alleged abuses in deferred giving and wrote stringent rules limiting the use of deferred giving as a means of encouraging a donor's philanthropy of his or her choice. By enacting such provisions of law such as section 2055(e)(2) and section 664 of the Internal Revenue Code to require donors to give property to either charitable remainder annuity trusts or charitable remainder unitrusts, the Congress unfortunately encouraged the Internal Revenue Service to create a maze of difficult, intricate, inconsistent and improvident regulations governing this form of deferred giving. Charities now pay a very high price for any scrivener's errors or omissions.

In recognition of the continuing experience of the existence of unqualified instrument which these statutes created, the Treasury Departemnt, until December 31, 1972, at its own initiative, permitted executors of estates to reform or amend trusts created under wills, or inter vivos trusts, to meet the new rules. Thus, trusts which had been written wrongly, if re-written, in the proper format, would be treated as properly written in the first instance and a deduction would be nevertheless allowed. The Shriners Hospitals for Crippled Children, with other charities, encouraged the Congress, beginning in 1972, to enact into law similar reformation relief after the Treasury Department's reformation period expired on December 31, 1972. This the Congress did in 1974 by enacting section 2055(e)(3) with the right of reformation extended to December 31, 1975. The reformation date was twice extended by Congress as its members obviously recognized the great difficulties created by the existence of section 664 and section 2055(e)(2).

We wish to go on record supporting the extension of time under existing law provided for by H.R. 7220. H.R. 7220 is a counterpart to a provision added to H.R. 2492 by the Senate Finance Committee and originally reported by the Finance Committee on December 19, 1979, as part of H.R. 1212. The reasoning contained in Senate Report 96-684, 96th Cong., 2d Sess., May 6, 1980, adequately describes the continuing need for relief from the stringent rules provided by such provisions as section 2055(e)(2) and section 664. Giving estates and trusts the opportunity to reform, and thereby obtain the charitable contribution deduction for federal income, gift or estate tax purposes, and giving the trusts the opportunity to be tax exempt from federal income tax as provided for by section 664(c), enhances the ability of charities to utilize this form of deferred giving as part of their overall program encouraging their financial support.

We would like to suggest a slight change in H.R. 7220. Under section 2055(e)(3) as presently written, an instrument transferring a charitable remainder (e.g., will or deed of trust) must be in effect on December 31, 1977 or the trust must have been established by that time. It is our opinion that this December 31, 1977 date should be made coterminous in effect with the December 31, 1980 filing date prescribed by H.R. 7220. Having disparate dates between filing reformation actions (December 31, 1980) and when the will was drafted is simply not justified by any rule of equity or revenue loss.

At the present time, the staff of the Joint Committee on Taxation and the Office of the Tax Legislative Counsel, of the U.S. Treasury Department, and various interested charities are working to develop a permanent solution to the problems of unqualified transfers. Short of repeal of the villainous rules of section 2055(e)(2), etc., permanent relief for unqualified charitable remainders is a sensible way to assure that no windfall taxes accrue to the Government. Permanent relief also has the advantage of not causing the Congress to face this relief question on a continuing basis as various charities seek redress of their grievances under existing law to concerned Members. A piecemeal approach to relief to resolve [illegible] problems created by the strict rules governing deductibility of charitable remainders is very unacceptable, being both inefficient and unsound tax policy. Although a permanent relief provision will not be enacted in this 96th Congress, we hope that the Subcommittee will give it the same timely consideration that it has given the temporary relief provisions in the past. As an introduction to this problem, I would like the record to reflect preliminary work in this area.

Shriners Hospitals for Crippled Children wants to be on record that section 2055(e)(2), and corresponding provisions of the income tax laws (section 170 (e)(2)), and corresponding provisions of the income tax laws (section 170(e) (2)) and gift tax laws (section 2522(c)(2)) are a very considerable impediment to charitable giving. If the Congress believes that there is inadequate evidence to justify repeal of these provisions, we believe that the right of reformation for unqualified trusts should be a permanent part of the law. We wish to make it very plain that section 2055(e)(2) and section 664, requiring complex annuity trusts or unitrusts have not benefited the charities as they were purportedly intended to do, but have simply caused them to lose many gifts. Gifts are lost because of donor confusion, fright and wonderment over whether the deduction will be available. This concern is heightened, of course, by the refusal of the Internal Revenue Service Estate and Gift Tax Branch to rule on trusts contained in wills of living persons.

Repeal of section 2055(e)(2), for example, would not harm charities or defraud the fisc because the charities' interest in a charitable remainder trust is protected by the private foundation excise taxes imposed upon such trusts under Chapter 42 of the Internal Revenue Code. We hope that next year, the Subcommittee will concern itself with methods which encourage deferred giving and not thwart the interests of many charitable inclined individuals who feel that present law is simply too rigid and complex.

[The following was subsequently received:]

Mr. JOHN M. MARTIN, Jr.,
Chief Counsel, Committee on Ways and Means,
U.S. House of Representatives.

DEAR MR. MARTIN: On June 19, 1980, the Subcommittee on Miscellaneous Revenue Measures received testimony on a variety of bills, including H.R. 4175. H.R. 4175 is a bill which would allow a charitable contribution deduction to a fraternal society if used for the construction and maintenance of buildings housing the principal activities of such societies.

During the course of the testimony of Mr. Henry C. Clausen, he indicated that H.R. 4175 would benefit "all organizations of Sec. 501(c)(10)" and then went on to name a number of fraternal organizations including the Knights of Columbus. This is to advise you that the Knights of Columbus would not be benefitted by H.R. 4175. The undersigned serves as tax counsel to the Knights of Columbus and you should be advised that the Knights of Columbus, the Supreme Council and its subordinate councils, are fraternal organizations described in Sec. 501(c)(8) of the Internal Revenue Code.

The Knights of Columbus are not Sec. 501(c)(10) organizations because they provide life, sick, accident and other benefits of an insurance nature to its membership. Because H.R. 4175 would not benefit the Knights of Columbus, we wish the record of the hearing should reflect that situation.

I have been authorized by the Supreme Council of the Knights of Columbus to state that the Supreme Council of the Knights of Columbus neither opposes nor supports H.R. 4175.

Very truly yours,

WILLIAM J. LEHRFELD.

STATEMENT OF JOHN H. MYERS, COUNSEL, AMERICAN COUNCIL ON EDUCATION

Mr. MYERS. Mr. Chairman, I am Jack Myers. I am here on behalf of the American Council on Education, which is a major association of colleges and universities. It has approximately 70 percent of the public colleges and 80 percent of the private colleges in its membership, and also includes a number of regional and national educational associations.

All of its members are exempt under IRC section 501(c)(3) or as public entities ACE itself also is an exempt educational entity recognized as such by the Internal Revenue Service.

As Mr. Lehrfeld said, we are here to endorse the bill. However, we are here primarily to make a plea that the time has come for a permanent solution to this particular problem. This bill would only extend the date for correction to 1980. It would still apply only to an instrument created before or during 1977.

We in the college and university fraternity are aware of a number of instruments executed since 1977, mainly wills, which are invalid for one reason or another under Internal Revenue Service Rules.

In some cases the instrument merely includes an error or a misinterpretation of the rules or guidelines of the Internal Revenue Service. In others, the drafter has included a provision which is prohibited by the statute, such as the power of invasion. In others, the drafter was not aware of unpublished (or published as private-letter-ruling) holdings of the Internal Revenue Service with respect to drafting of instruments.

If I might just digress for a minute, let me give you one or two experiences of mine in this area. In one instance, a will was drafted by "the" recognized probate authority in a major area. For some reason, he simply drafted an instrument which did not qualify. Fortunately, we were able to utilize one of the previous extensions and we were able to correct it.

In another instance, just this year, I had a lawyer ask me to review his will. He had drafted a charitable remainder trust. He was familiar with the guidelines published by the Internal Revenue Service and attempted to comply with them. When I reviewed the draft, I had to tell him he had made six mistakes. One was a mere error, typographical error. Any one of the other errors would have disqualified the trust.

This is something which is going to come up from time to time. A characteristic college, major institution, very sophisticated and knowledgeable has had five of these invalid trusts or wills over the past 7 or 8 years and has had to correct under the present statutes and can expect to be required again.

We would certainly urge that consideration be given to a permanent solution. One problem that I have, and I think it is most important, is that this situation is such that the creation of charitable remainder trusts is being inhibited. Most lawyers are not familiar with them. If they are familiar, they are aware of the restrictive attitude of the Internal Revenue Service and the problems of drafting. Because of the obvious latent problem of malpractice, they discourage the creation of charitable remainder trusts.

I think that a permanent correction provision will relieve this concern. Thank you very much.

[The prepared statement follows:]

STATEMENT OF JOHN H. MYERS, ON BEHALF OF THE AMERICAN COUNCIL ON EDUCATION

1. I am John Holt Myers of Williams, Myers and Quiggle and am appearing on behalf of the American Council on Education. The American Council on Education is a council of national and regional education associations and institutions of higher education. Since its founding in 1918, the Council has been a center of cooperation and coordination for the improvement of education at all levels, with particular emphasis on higher education. Membership in the Council is by organization or institution, not by individual. There are institutional members from the 50 states, the District of Columbia, the Canal Zone, Guam and Puerto Rico representing 69 percent of the public and 80 percent of the private accredited institutions of higher education in the United States.

The present members and affiliates of the Council are as follows: 21 national and regional associations and organizations; 1,349 institutions of higher education; and 83 affiliated institutions and organizations. In addition to national and regional organizations having interests related to education, associated organization members include state departments of education, city school systems and private school systems.

All of the American Council on Education's member institutions of higher education have been ruled to be exempt from Federal income tax under IRC Section 501(a) as organizations described in IRC Section 501(c)(3). Some of the member public institutions of higher education have also been determined to be exempt IRC Section 501(c)(3) organizations. However, most of the public institutions are exempt from income tax under IRC Section 115(a).

2. The American Council on Education endorses H.R. 7220. However, for the reasons set forth below, it urges that the Subcommittee consider the enactment of a permanent provision under which governing instruments of charitable remainder trusts, charitable lead trusts and pooled income funds can be amended to meet the requirements of the Federal estate, gift and income tax law imposed by the Tax Reform Act of 1969 and, thus, preserve the assets of said trusts for the intended charitable remainderman.

3. Since the Tax Reform Act of 1969, the Congress has periodically enacted provisions permitting such amendments, the most recent of which as Section 413 of the Revenue Act of 1978 extended until December 31, 1978, the time to amend

(or commence judicial proceedings to amend) instruments establishing such trusts which were executed before December 31, 1977. H.R. 7220 in effect extends the amendment period to December 31, 1980, but only with respect to instruments executed on or before December 31, 1977.

4. We are aware of instruments creating charitable remainder trusts for the benefit of colleges and universities by will or lifetime instruments since December 31, 1977, which for one reason or another have been declared by the Internal Revenue Service to be invalid. If the trusts are subject to Federal estate, income and/or gift tax, the principal burden will fall on the colleges or universities or other charities as remaindermen. We feel equally certain that the institutions affected will bring to the attention of Congress the circumstances under which such instruments were created and seek legislative relief year by year as has happened in the past.

5. The reasons given for declaring the instruments invalid are varied.

(a) In some cases, the drafters of the instruments through unfamiliarity with the law and regulations have included provisions which are prohibited by the statute, such as a power of invasion for the benefit of a beneficiary even though the possibility of invasion is so remote as to be negligible.

(b) The drafters of the instruments, although familiar with the regulations and the governing instrument guidelines published in Revenue Ruling 72-395, 1972-2 C.B. 340, have misinterpreted these requirements or made clerical errors.

(c) The drafters of the instruments have run afoul of positions taken by the Internal Revenue Service some of which are unpublished or are published only in private letter rulings. The Internal Revenue Service has adopted a very narrow and restrictive attitude toward the governing instrument requirements. For example, in a Revenue Ruling recently published (Revenue Ruling 80-123, 1980-18 IRB 10), the Internal Revenue Service has taken the position that a provision which was included in Revenue Ruling 72-395 as "optional" is in fact "mandatory." Although the Service has indicated it will apply this rule only in the case of decedents dying after May 5, 1980, the ruling gives grantors only one year to amend such instruments. It seems clear that many drafters of charitable remainder trusts, particularly those who do not have a day-to-day familiarity with the rulings of the Internal Revenue Service, will not become aware of this provision until too late. Indeed, many of the drafters will never have an opportunity to review the instruments in question since they may no longer represent or have contact with the grantor.

6. We are particularly concerned at the effect of the present set of circumstances on the creation of charitable remainder trusts. As a general rule, lawyers throughout the country are not really familiar with charitable remainder trusts. Those who have some familiarity are well aware of the very restrictive attitude of the Internal Revenue Service and appreciative of the danger inherent in their drafting such instruments because failure to meet a standard expressed or unexpressed of the Internal Revenue Service in the drafting of such instruments will not only result in a denial of an income or estate tax deduction but also in the case of lifetime gifts may result in a gift tax on the remainder interest passing to charity. As a result, the creation of such trusts are inhibited. The presence of a provision permitting amendment would relieve this concern.

7. We feel confident that, as every year goes by, worthy cases deserving the consideration of Congress will be brought to its attention, leading to subsequent extensions of the right to amend. For this reason we recommend that serious consideration be given to a permanent provision for amendment which will permit the intent of Congress in enacting the 1969 Act provisions to be given effect. The beneficiaries of such a provision will be the charities which would otherwise have their remainder interests depleted by a tax where a charitable gift or bequest was clearly intended.

Mr. ROSTENKOWSKI. Thank you, gentlemen. Thank you very much.

Mr. MYERS. I do request that our written statement be placed in the record.

Mr. ROSTENKOWSKI. Your entire statement will be included.

Mr. MYERS. Thank you.

Mr. ROSTENKOWSKI. Messrs. Rey, Evans, Hunter, Groom, McIntyre, Gore, and Hennesy.

Now that we are all in place, gentlemen, the committee will stand in recess for 5 minute so that I can go and vote. I will be back.

[A recess was taken.]

Mr. **Rostenkowski.** We welcome our final panel of witnesses. You know what the time limitations are. I would appreciate you trying to stay within the time constraints. If you have a statement that is longer than your allocated time, I want to assure you it will be placed in the record in its entirety.

I would like to have you stay within your time frame principally so that at the conclusion of Mr. Hennessy's testimony we could have a brief discussion among the panelists. Mr. Rey.

STATEMENT OF NICHOLAS A. REY, CHAIRMAN, INTERNATIONAL COMMITTEE, SECURITIES INDUSTRY ASSOCIATION, ACCOMPANIED BY JOHN C. EVANS, MEMBER, INTERNATIONAL COMMITTEE

Mr. **Rey.** Thank you, Mr. Chairman. I am Nicholas Rey, an officer of Merrill Lynch and chairman of the Securities Industry Association's International Committee. With me is John C. Evans, a member of that committee. Robert V. Roosa, chairman of the New York Stock Exchange's Advisory Committee of International Capital Markets, on which I also serve, has asked me to express his regret that previous commitments prevented his joining in our testimony this morning.

Mr. Chairman, we are here to urge elimination of the U.S. tax, which ranges up to 30 percent, on interest payments to foreign portfolio investors.

By reducing the rate of return to foreign investors, the foreign withholding tax makes U.S. Government and corporate debt instruments decisively uncompetitive with alternative investments in the $52 billion Euro-dollar bond market.

For example, if a foreigner has an opportunity to buy a dollar bond issued by an agency of the French Government at 10 percent or 10 percent bonds issued by the U.S. Treasury, he would pick the French Government bonds because the 30 percent withholding tax reduces his yield to 7 percent on the U.S. bonds.

Even if he can receive a credit for the 30 percent tax at some future date against his domestic tax, he will forfeit the use of his money until he receives the credit.

Separate and independent surveys conducted by Merrill Lynch and Morgan Stanley demonstrate the magnitude of this disadvantage. The surveys indicate that repeal of the foreign withholding tax would result in an annual inflow of $5 to $7 billion into U.S. debt markets.

Repeal of the foreign withholding tax would: Supplement the flow of domestic savings into productive investment; help increase employment, improve productivity and reduce inflation; improve the U.S. balance of payments; strengthen the dollar; contribute to lower long-term interest rates; attract foreign purchasers for long-term debt securities; and provide a clear signal that the U.S. welcomes foreign investment in its debt markets.

The foreign withholding tax discourages stable and desirable long-term investment. For sound reasons, Congress in 1976 removed the tax for short-term obligations, including bank deposits. Nor does the tax apply to commercial paper or U.S. Treasury bills.

But the unintended effect is that long-term investment has been discouraged while more volatile short-term investment has been favored and fostered. The volatility of short-term investment has been demonstrated twice this year.

Earlier, as interest rates in this country soared, we experienced a massive influx of short-term foreign investment. But in recent weeks the decline of interest rates has been accompanied by a sizable outflow of short-term funds.

The foreign withholding tax served as a barrier to a compensating infusion of long-term investment which otherwise should have paralleled the simultaneous increase in bond prices.

Repeal would correct the imbalance, to the benefit of our economy, and is consistent with international tax principles and practice. While profits from the sale of real estate are customarily taxed by the country in which the property is located, interest is generally taxed by the recipient's home country.

Moreover, the salutory effects of repealing the foreign withholding tax can be achieved without significantly reducing tax revenues, fostering tax evasion by U.S. citizens or incurring the risks of foreign ownership and control of U.S. assets or corporations. Repeal would not discriminate against Americans; rather, it would provide them the ability to borrow from foreign investors.

Mr. Chairman, we commend your efforts to attract long-term foreign investment. We support the thrust of your bill and have submitted some recommended modifications which will remove administrative barriers to the desirable results it is intended to achieve. As Secretary Lubick indicated this morning, the proposal was worked out with the Treasury Department to insure that the legislation will not foster tax evasion by Americans. I ask that those recommendations be included in the record.

We thank you for the opportunity to participate in these hearings and would be happy to answer any questions you may have later.

[The prepared statement follows:]

Statement of Nicholas A. Rey, on Behalf of the Securities Industry Association

We appreciate this opportunity to appear before the subcommittee to support elimination of the U.S. tax on interest payments to foreign portfolio investors. I am appearing in my capacity as Chairman of the International Committee of the Securities Industry Association and as a member of the New York Stock Exchange Advisory Committee on International Capital Market. Mr. Robert V. Roosa, Chairman of the stock exchange committee, regrets that previous commitments prevent him from being here to support elimination of the tax. With me is John C. Evans, Managing Director of Morgan Stanley, and a member of SIA's committee.

CURRENT LAW DISCOURAGES FOREIGN INVESTMENTS

Under current law, the United States imposes a tax of up to 30 percent on interest payments made to foreign investors. This tax is collected in its entirety by withholding at source. It is therefore called a withholding tax, although it is not analogous to a domestic withholding tax which is a means of advance collection of a tax otherwise due at a later date.

To some extent, this 30 percent rate may vary depending on tax treaties. American debt obligations, burdened with this tax, must compete with the Eurodollar bond market which is not burdened by any so-called withholding tax. The net effect of the U.S. tax, in most cases, is to reduce the return on interest bearing securities issues in the United States by up to 30 percent. This reduced return makes United States Government and corporate obligations decisively uncompetitive with alternative investments available in the $52 billion Euro-dollar bond market. The tax, therefore, creates an insurmountable barrier to investment in longer term United States Government and corporate debt securities by most foreign private individuals and institutions.

THE NEED TO REPEAL THE TAX

Separate and independent surveys, conducted by Merrill Lynch and Morgan Stanley have convinced us that the repeal of the tax on debt interest would stimulate an inflow of an estimated $5 to $7 billion annually into the United States capital markets. This will:

Supplement the flow of domestic savings into productive capital investment at a time when all such flows are vital to help increase employment, improve productivity and reduce inflation;

Improve the United States balance-of-payments and help offset our burgeoning foreign oil bill;

Strengthen the dollar, while contributing to lower long-term interest rates, in contrast to a strengthening of the dollar through higher short-term interest rates as witnessed earlier this year;

Benefit the United States bond markets, both government and corporate, for new offerings as well as for existing issues;

Bring back to the United States some of the international bond activity and, therefore, restore jobs which are now performed offshore in the Euro-markets.

Repeal of the tax would also enhance the flexibility of U.S. authorities in carrying out international monetary measures in support of the dollar. It would make it possible for the Treasury to issue long-term securities designed for sale to private foreign buyers as well as allowing private foreigners to participate in long-term Treasury financing in this country.

Importantly, repeal of the tax on interest would provide a wide range of American business the benefits of foreign investment funds without the risks of transfer of control that worry many people. We favor repeal of only the tax on interest payments to portfolio investors, i.e., "unaffiliated foreigners".

PORTFOLIO INVESTMENTS SHOULD BE ENCOURAGED

It is important to note that the existing tax discourages exactly the type of investment which we want to attract—the long-term portfolio investor primarily interested in income.

The income taxes imposed by various states provide a useful analogy. Although states routinely tax non-residents on wages earned or income produced from a business carried on within their borders, they carefully steer away from taxing investment income of non-residents. For instance, those who work in New York but live in New Jersey or Connecticut are taxed by New York on their New York earnings. But their interest on New York savings accounts is untouched—not because New York wants to be generous, or doubts its legal prerogative, but because it knows non-residents would just remove investments to a friendlier jurisdiction. The same, of course, is true of interest paid by New York-based companies.

The lesson is clear, whether locally or internationally: when investments of non-residents are taxed, borrowers within that taxing entity are placed at a competitive disadvantage. It is a disadvantage which American enterprises and government entities seeking capital should not bear.

Indeed, the Congress has already recognized the need to remove this competitive disadvantage in respect of short-term obligations. The tax was permanently removed in 1976 from foreigners' interest-bearing bank deposits (including Certificates of Deposit). The tax also does not apply to such other short-term investments as commercial paper and U.S. Treasury bills. Not only does this discriminate in favor of one category of American capital seekers at the expense of others, it favors quickly-shiftable short-term investments by foreigners at the expense of more stable, and therefore more desirable, long-term investment.

NEED TO ENCOURAGE FOREIGN INVESTMENT

Mr. Chairman, the policy of the United States has always been one of welcoming a free-flow of foreign capital into our country, particularly into our debt markets. The freezing of the Iranian assets, however, has had the effect, albeit

unintended, of casting a substantial shadow over this policy in the m
foreigners. In addition, Congress is contemplating taxing foreigners o
capital gains from real estate in the United States and restraining for
from gaining control of American banks.

While concerns about each of these issues are understandable, it is u
nate that all signals currently being given to foreign investors indicate t
traditional welcome mat is being pulled in. The question in the minds o
foreigners as to how far this apparent change in United States policy
is tending to shake confidence in the United States as a "safe pla
investment.

In view of these recent events, we believe it is critical to show for
without delay that these current negative signals are false signals. The
and general removal of the tax on foreigners' portfolio bond interest wou
vide a clear sign that this country welcomes foreign capital into its deb
kets. This message can be conveyed with great benefit to the American ec
with no risk of encouraging foreign control of American business and, f
at virtually no direct revenue cost.

ESTIMATED REVENUE EFFECT

The direct loss of revenue would be insignificant from repeal of the
interest paid to portfolio investors. Latest available IRS statistics indica
total revenue in 1977 from the tax on interest payments was $33 millio
of this revenue represents tax on inter-corporate interest payments fro
subsidiary companies to their foreign parents. Under the legislation we
of course, such inter-corporate payments would continue to be subject
tax.

It is worth noting, moreover, that the elimination of foreign tax
generated by the use of Netherlands Antilles financing subsidiaries, which
be the likely result of passage of this legislation, would offset all or a su
tial part of the small direct revenue cost.

The small direct revenue generated by the tax is an excellent indicato
the tax truly acts as a barrier to investment here, a sort of protective
that keeps out badly needed capital and investment.

While the direct loss in revenue would be insignificant, and the net los
haps nil, the potential benefits to the federal budget could well be subst
First, new floors of foreign funds into long-term government notes and
would, to some degree, lower the rates which the Treasury would othe
have to pay, thereby reducing federal expenditures. Second, a $5 to $7
inflow of new capital would tend to increase investment and jobs in the
States thereby resulting in higher federal tax revenues because of the expa
incomes which are generated.

ESTIMATED INFLOWS OF CAPITAL

Two securities firms recently carried out surveys to determine estima
the capital inflows to be expected from removal of the tax. The surveys
totally independent of each other and used different methods. Merrill Lync
veyed the managers of its worldwide international office network and, bas
its market share, concluded that some $5 billion in new portfolio investme
U.S. corporate and government bonds could be expected if a portion of fo
portfolios was shifted into U.S. bonds. Morgan Stanley, on the other hand
veyed directly key institutional investors abroad and concluded that the sh
a portion of Euro-dollar bond portfolios into U.S. bonds could easily avera
billion annually.

It is quite possible that the flows may be even greater than those indi
by the surveys because neither study takes into account possible shifts o
other currency investments or out of short-term dollar investments. Th
size of the Euro-currency market was roughly $600 billion as of year-end
Even a 1 percent shift into U.S. portfolio investments would bring $5 b
back into the U.S. economy. Judging from long standing experience with
British War Loan, on which foreigners pay no British tax, the use of
Treasury obligations by foreigners as cash equivalents in lieu of far less l
Euro-dollar instruments could be truly substantial. Accordingly, it would a
that even the $7 billion estimate may well understate the potential inflow

capital that would result from repeal of the tax on foreign portfolio interest income.

THE TAX AND TREATIES

Since the 1930s, the United States has imposed a tax withheld at the source at a flat 30 percent rate on gross interest to foreigners. However, the 30 percent rate has been reduced or eliminated for residents of a number of countries, including several major industrial nations, with which the United States has treaties to prevent double taxation. For example, the tax has been reduced to zero for U.K., German and Dutch residents, and is imposed at a 5 percent rate for Swiss residents and 10 percent for Japanese residents. However, the U.S. lacks such treaties with the majority of countries around the world. Among these are some very substantial sources of funds for investment in the United States. In view of the history of unsuccessful attempts to negotiate-treaties with many of these countries, it is unlikely that further negotiation efforts would result in such tax agreements in the foreseeable future. The withholding tax, in any event, is not an effective bargaining counter as foreign governments generally have little interest in encouraging their nationals to invest in the U.S.

An important point is that while the Swiss tax treaty reduces the rate to 5 percent on interest, this rate applies only to Swiss residents. However, when a non-Swiss resident invests in the U.S. through his Swiss account, Switzerland, under the treaty, withholds additional amounts and remits them to the United States in order to bring the tax paid by such investors to the 30 percent rate. And significantly, the vast majority of funds available in Switzerland for investment in the United States is for the account of non-Swiss residents.

In many countries, any withholding taxes paid to the United States can be credited by the foreign nationals against their own domestic tax bills. However the procedures involved are often cumbersome and time-consuming. They, therefore, do not facilitate the free-flow of funds to the United States. This is particularly true in the case of individual foreign investors. In addition, even if a foreign investor can get full credit at home, he is unable to use the amount withheld until he obtains the credit and this is viewed by many lenders as effectively reducing their rate of return. Finally, just as in the United States, a number of important institutions in Europe, such as pension funds, pay no domestic tax and therefore cannot take advantage of foreign tax credits.

Under current law, foreign official institutions, such as central banks and monetary authorities, are already exempt from the tax if their investments are related to "a government purpose." This exemption has been vitally important in the recycling of significant amounts of official Arab OPEC funds to the United States, although there is growing concern that the scope for further recycling of this type may be limited. At the same time, OPEC surpluses are flowing at an accelerating rate into the hands of private citizens in those countries. Recycling of these private funds into American debt securities, however, is effectively blocked by a 30 percent tax, which cannot be credited domestically since no income taxes are levied by the countries with the major balance of payments surpluses.

Thus, under existing circumstances, because of tax treaties and exemptions such as those for governments or on Certificates of Deposits, the foreigner faces a patchwork of discriminatory treatment. If we need foreign capital in our debt markets, why should we care if the investor is a government, an Englishman, Swiss or Venezuelan. Indeed, why should the Venezuelan pay 30 percent when the Englishman pays nothing.

NO DISCRIMINATION AGAINST AMERICANS

It has been argued that repeal of the withholding tax would discriminate against American investors because they would continue to be subject to U.S. income taxes while foreigners would pay no tax on their U.S. investments. It has also been suggested that repeal of foreign withholding taxes would turn the United States into a "tax haven." However, these arguments ignore the long accepted principle of international taxation—that portfolio investors should be subject to tax in their own country of residence or nationality.

Moreover, since the tax acts as a barrier to investment and very little investment comes here subject to the tax, repeal would not remove a tax which is actually being paid. Repeal would not discriminate against U.S. citizens, it, rather, should be viewed as making it possible for them to borrow from foreigners.

TAX AVOIDANCE BY AMERICANS

Repeal would not, as some have argued, encourage tax evasion by Amer
We now have adequate statutory reporting and enforcement measures to co
tax evasion. For example, the Currency and Foreign Transactions Reportin
requires Americans to report all transfers of monetary instruments into o
of the United States and bank or securities accounts held abroad.

Further, we would expect that any legislation reported by the Committee
incorporate reasonable anti-evasion mechanisms by requiring foreigners wh
ceive interest to certify that they are not themselves, nor, in the case of nomi
are they holding the securities on behalf of, U.S. persons. We also suggest
the Secretary of the Treasury be authorized to reimpose the tax on interest
ments to countries that are unwilling to exchange information where suc
formation is required to prevent evasion by Americans.

We would add that there are uncertainties in the Senate Finance Comm
Amendment and the Committee Report that could substantially impede
marketability of U.S. Government and corporate obligations to legitimate fo
investors and thereby defeat the purpose of the legislation. Those uncertai
can be rectified without fostering tax evasion by Americans.

Mr. Chairman, we commend you for your efforts to attract badly needed
term investment funds into the United States in a manner which will not
mote foreign control of American businesses or real property. We urge tha
legislation be framed in terms that make this purpose clear to foreign inve
who control those funds.

ADDENDUM

SECURITIES INDUSTRY ASSOCIATION,
Washington, D.C., June 18, 19

Hon. DANIEL ROSTENKOWSKI,
Chairman, Subcommittee on Select Revnue Measures,
Longworth House Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: In testimony prepared for delivery before the sub
mittee tomorrow on behalf of the Securities Industry Association, Nichola
Rey alludes to modifications of the bill's language which are intended to re
barriers to the legislation's intended results. Those recommendations were
completed in time to be submitted with the testimony which was submitted
morning in compliance with the committee's rules.

The modifications are embodied in the attached material which include
comparison of the proposed language to H.R. 7553, and a draft of the prop
bill, together with a statement on the bill and a technical explanation of it.
would appreciate it if this material could be included in the hearing record
part of the Association's testimony.

The principal objective of the modifications are to ensure that the legisla
will not permit U.S. persons to evade U.S. income tax, while avoiding a diff
and sometime impossible requirement that the beneficial owner be determi

Additional copies of this letter and the attached materials have been prov
for the Subcommittee's use.

Sincerely,

STEPHAN K. SMALL,
Vice President and Director
of Congressional Relatio

COMPARISON OF H.R. 7553 AND H.R. 2297 (AS AMENDED BY THE SENATE FINA COMMITTEE) AND NEWLY PROPOSED LEGISLATION FOR THE REPEAL OF U.S. TA FOREIGN PORTFOLIO DEBT INVESTMENT INCOME

In December, 1979, the Senate Finance Committee amended H.R. 2297 to re
the 30 percent U.S. withholding tax on interest paid to foreign investors o
than foreign investors who are affiliated with the borrower (by reason of
percent interest in corporate stock or partnership capital or profits) or who
controlled foreign corporations. Where the payor of interest does not k
whether the recipient is exempt from tax, his obligation, if any, to withhol
left to regulations to be promulgated by Treasury.

The new draft of legislation which exempts from U.S. tax income from for
portfolio debt investment provides better guidance to U.S. payors of interes
respect of their obligations while, at the same time, it provides greater assura

that the exemption is limited to the intended class of foreign persons. The draft does so through the following provisions:

Interest exempt from tax includes only (a) interest on existing obligations hereafter assumed by a domestic corporation if such obligations were issued under arrangements reasonably designed to ensure sale only to non-U.S. persons; (b) interest on bearer obligations issued under arrangements reasonably designed to ensure sale only to non-U.S. persons; and (c) interest on registered obligations where the paying agent has received a statement from the beneficial owner of the obligation or from a nominee financial institution that the beneficial owner is not a U.S. person. In the case of the latter two exemption categories, the exemption would not be available to a beneficial owner who has a 10 percent or greater stock or partnership interest in the borrower or to a beneficial owner who is a controlled foreign corporation.

The Secretary of the Treasury is given discretion to remove the exemption from tax for interest payments to persons within a foreign country with which there is an inadequate exchange of information with the United States income tax by United States persons. This provision is continued from the Senate Finance Committee amendment.

The Secretary of the Treasury is given the authority to determine that certifications as to beneficial ownership provided by a particular financial institution or a class of financial institutions may be unacceptable for purposes of the exemption.

The interest paying agent's withholding obligations are clarified so that there need be no withholding unless the paying agent knows or has reason to know the interest is not exempt from tax because the paying agent is affiliated with the borrower within the meaning of the 10 percent test.

Although no withholding is required on interest payments made to controlled foreign corporations, such corporations are nevertheless liable for the payment of U.S. tax in respect of their U.S. interest income.

[Legislative Draft]

Be it enacted by the Senate and House of Representatives of the United States of America in Congress Assembled

(a) TREATMENT OF CERTAIN INTEREST.—

(1) IN GENERAL.—Subsection (a) of section 871 of the Internal Revenue Code of 1954 (relating to tax on nonresident alien individuals) is amended by adding at the end thereof the following new paragraph:

"(3) INCOME OF NONRESIDENT ALIEN INDIVIDUALS RECEIVED FROM CERTAIN PORTFOLIO DEBT INVESTMENTS.—No tax shall be imposed under subsection (a)(1) on interest (including original issue discount) received by a nonresident alien individual if—

(A) the interest is paid on an obligation which resulted from the assumption after the date of enactment of this Act by a domestic corporation of an obligation which was issued on or prior to such date and which, when issued, was guaranteed by a domestic corporation and was sold, directly or through underwriters, under arrangements reasonably designed to ensure that such obligation would be sold only to a person who was not a United States person, or

(B) the interest is paid outside of the United States on an obligation which is in bearer form and which, when issued, was sold, directly or through underwriters, under arrangements reasonably designed to ensure that such obligation would be sold only to a person who was not a United States person, or

(C) the interest is paid on an obligation which is not in bearer form, the United States person who would otherwise be required to deduct and withhold tax from such interest under Section 1441 (a) has received a statement that the beneficial owner of the obligation is not a United States person and such statement meets the requirements of subsection (g).

but in the case of interest paid on an obligation described in subparagraph (B) or (C) only if (i) in the case of interest received from a corporation, the non-resident alien individual does not own, and is not considered as owning (within the meaning of subsection (h)), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such corpora-

tion, or (ii) in the case of interest received from a partnership, the nonreside
alien individual does not own and is not considered as owning (within t
meaning of subsection (h)), 10 percent or more of the capital or profits inter
in such partnership."

(2) CERTAIN STATEMENTS; CONSTRUCTIVE OWNERSHIP.—Section 871 of su
Code (relating to tax on nonresident aliens) is amended by redesignating su
section (g) as subsection (i) and by adding after subsection (f) the followi
two new subsections:

"(g) CERTAIN STATEMENTS.—A statement with respect to the ownership of
obligation shall meet the requirements of this subsection if such stateme
represents that it is from the beneficial owner of the obligation or such sta
ment is from a securities clearing organization, a bank, or other financi
institution that holds customers' securities in the ordinary course of its bu
ness, and within the period ending one month prior to the payment of intere
the Secretary has not published a determination to the effect that statemen
from such securities clearing organization, bank, or other financial institutio
or any class of such persons, may not be accepted for the purposes of th
subsection.

(h) CONSTRUCTIVE OWNERSHIP.—Section 318(a) (relating to the constructi
ownership of stock), other than paragraph (1) thereof, shall apply for t
purposes of determining ownership of stock of a corporation under subsecti
(a)(3) and Section 881(c), and similar rules shall apply for the purposes
determining ownership of an interest in a partnership under subsection (a)(
and Section 881(c). For the purposes of the preceding sentence, Section 318(
(2)(C) shall be applied without regard to the 50 percent limitation contain
therein, and stock of a corporation or an interest in a partnership owned by
person by reason of the application of Section 318(a)(4) shall not, for t
purposes of applying paragraphs (2) and (3) of Section 318(a), be consider
as actually owned by such person."

(3) CONFORMING AMENDMENT.—Section 871(a)(1) of such Code is amend
by striking out "There" and inserting in lieu thereof "Except as provided
paragraph (3), there".

(b) FOREIGN CORPORATIONS.—

(1) IN GENERAL.—Section 881 of such Code (relating to tax on income
foreign corporations) is amended by redesignating subsection (c) as subsectio
(d) and by adding after subsection (b) the following new subsection:

"(c) INCOME OF FOREIGN CORPORATIONS RECEIVED FROM CERTAIN PORTFOLIO DE
INVESTMENTS.—No tax shall be imposed under subsection (a) on interest (inclu
ing original issue discount) received by a foreign corporation if—

(1) the interest is paid on an obligation described in Section 871(a)(
(A), or

(2) the interest is paid on an obligation described in Section 871(a)(
(B), or

(3) the interest is paid on an obligation which is in registered form, t
person who would otherwise be required to deduct and withhold tax fro
such interest under Section 1442(a) has received a statement that t
beneficial owner of the obligation is not a United States person, and su
statement meets the requirements of Section 871(g).

but in the case of interest paid on an obligation described in subsection (2)
(3) only if (i) the interest is received by a corporation that is not a controll
foreign corporation, (ii) in the case of interest received from a corporatio
the corporation receiving the interest does not own, and is not considered
owning (within the meaning of Section 871(h)), 10 percent or more of t
total combined voting power of all classes of stock entitled to vote of su
corporation, and (iii) in the case of interest received from a partnership, t
corporation receiving the interest does not own, and is not considered as ow
ing (within the meaning of Section 871(h)), 10 percent or more of the capit
or the profits interest in such partnership."

(2) CONFORMING AMENDMENT.—Section 881(a) of such Code (relating
imposition of tax) is amended by striking out "There" and inserting in lie
thereof "Except as provided in subsection (c), there".

(c) AMENDMENT OF SECTION 864(c)(2).—Section 864(c)(2) of such Cod
(relating to effectively connected income) as amended

(1) by striking out "Section 871(a)(1) or Section 881(a)"; and

(2) by inserting "Section 871(a)(1), Section 871(a)(3), Section 881(a
or Section 881(c)".

(d) **Removal of Exemption From Tax in Case of Inadequate Exchange of Information.**—

(1) Subpart C of part II of subchapter N of chapter 1 of such Code (relating to miscellaneous provisions) is amended by adding at the end thereof the following new section:

"SEC. 898. REMOVAL OF EXEMPTION FROM TAX IN CASE OF INADEQUATE EXCHANGE OF INFORMATION

"Whenever the Secretary determines that the exchange of information between the United States and a foreign country is inadequate to prevent evasion of the United States income tax by United States persons, the exemption from tax contained in Section 871(a)(3) and Section 881(c) shall not apply to any payment or payments addressed to or for the account of persons within such foreign country after the date specified in the Secretary's determination. Any such removal shall not apply to interest on obligations issued on or before the date of publication of such determination. The removal of the exemption from tax contained in Section 871(a)(3) and Section 881(c) shall continue until the Secretary determines that the exchange of information between the United States and the foreign country of such information is adequate to prevent the evasion of the United States income tax by United States persons."

(2) The table of sections for such subpart C is amended by adding at the end thereof the following new item:

"Sec. 898. Removal of exemption from tax in case of inadequate exchange of information."

(e) **Amendment of Section 2105.**—Subsection (b) of Section 2105 of such Code (relating to property without the United States) is amended to read as follows:

"(b) **Bank deposits and certain other debt obligations.**—For purposes of this subchapter—

"(1) amounts described in Section 861(c), if any interest thereon would be treated by reason of Section 861(a)(1)(A) as income from sources without the United States were such interest received by the decedent at the time of his death,

"(2) deposits with a foreign branch of a domestic corporation or domestic partnership, if such branch is engaged in the commercial banking business, and

"(3) debt obligations, if, without regard to whether a statement meeting the requirements of Section 871(g) has been received, any interest thereon would be eligible for the exemption from tax under Section 871(a)(3) were such interest received by the decedent at the time of his death,

shall not be deemed property within the United Stnes."

(f) **Withholding.**—

(1) **Nonresident aliens.**—Subsection (c) of Section 1441 of such Code (relating to withholding of tax on nonresident alien individuals) is amended by adding at the end thereof the following new paragraph:

"(9) **Income exempt from tax.**—No deduction or withholding shall be required in the case of interest (including original issue discount) described in subparagraph (A), (B) or (C) of Section 871(a)(3) unless the person otherwise required to deduct and withhold shall know, or have reason to know, that such item of income is not exempt from tax because of clause (i) or (ii) of Section 871(a)(3).

(2) **Foreign corporations.**—That last sentence of Section 1442(a) of such Code is amended—

(A) by striking out "and" after "Section 881(a)(4),"; and

(B) by inserting ", and the reference in Section 1441(c)(9) to clauses (i) and (ii) of Section 871(a)(3) shall be treated as referring to clauses (ii) and (iii) of Section 881(c)" after "Section 881(a)(3)".

(g) **Effective Date.**—

(1) The amendments made by this section (other than subsection (e)) shall apply to amounts paid after the date of enactment of this Act.

(2) The amendment made by subsection (e) shall apply to the estates of decedents dying after the date of the enactment of this Act.

STATEMENT

This bill would amend the Internal Revenue Code to exempt from both United States income and withholding taxes the interest (and any original issue discount) on certain debt obligations of U.S. corporations held by nonresident aliens and foreign corporations if such interest was not effectively connected with a United States business of the holder.

Under current law income tax at the rate of 30 percent must be withheld on interest paid by United States corporations to nonresident aliens and foreign corporations not doing business in the United States. No significant exceptions permit, as a matter of practice, a domestic corporation to sell its debt obligations abroad. The exemption enacted in 1971 in connection with the Interest Equalization Tax lapsed when that legislation expired in 1974. Although a number of United States tax treaties with other countries eliminate the withholding tax on interest paid to residents of the other countries, these provisions are of little use for broadly distributed issues because such treaties do not cover all foreign countries.

It is not practical for U.S. corporations to assume the cost of the U.S. withholding tax by increasing the rate of interest, and foreign capital markets will not buy obligations if interest payments are reduced by withholding taxes. In order to eliminate the U.S. withholding tax, United States corporations that have borrowed abroad in foreign capital markets have done so through finance subsidiaries, usually formed in the Netherlands Antilles. Some use has also been made of domestic finance subsidiaries. The obligations of these finance companies are guaranteed by the United States parent. Although prior to July 1974, the Internal Revenue Service approved such issues by advance letter rulings, that is no longer the case. Approximately $5 billion of debt obligations have been sold in this way since June 1974.

It is questionable, as a matter of tax and economic policy, whether U.S. borrowers in foreign capital markets should be required to use financing subsidiaries. Moreover, foreign finance subsidiaries involve unnecessary costs and may interfere with the stated U.S. objective of renegotiating treaty arrangements with the Netherlands Antilles. It is important, however, to permit U.S. corporations to continue to have access to foreign capital markets, which are important to financing domestic investment. The U.S. Government's access to foreign capital market is also limited by the 30 percent withholding tax on interest.

The bill will eliminate the need to use Netherlands Antilles and other finance subsidiaries and permit obligations of U.S. issuers to be sold directly to foreign persons. Obligations of all U.S. borrowers will be covered, including obligations of domestic corporations, the U.S. government, its agencies, and corporations created or reorganized by Acts of Congress. The bill will apply to interest on three categories of obligations of such U.S. issuers.

(1) Interest paid on obligations sold to foreign persons by finance subsidiaries prior to enactment of the bill and assumed by a domestic corporation thereafter. This will permit U.S. issuers to collapse existing Netherlands Antilles and other finance subsidiary arrangements. Because these obligations have for the most part been issued under instruments that require the payment of interest without withholding, the restrictions (discussed below) on payments to controlled foreign corporations and to 10 percent or greater shareholders will not apply to those obligations.

(2) Interest paid on new obligations in bearer form which are sold, directly or through underwriters, under arrangements reasonably designed to ensure their initial sale only to foreign persons. Restrictions on sales to U.S. persons that are designed to avoid registration under the Securities Exchange Act of 1933 would satisfy the bill's requirement that the obligations be sold under arrangements reasonably designed to ensure their sale to foreign persons. This part of the exemption could, however, apply where only a part of an issue was sold under such arrangements. Obligations sold directly to foreign persons in a private placement would also be covered.

(3) Interest paid on obligations not in bearer form where the withholding agent has received a statement to the effect that the beneficial owner of the obligation is a foreign person. This would cover obligations in registered form as well as other obligations not in bearer form such as mortgages. A statement would be acceptable for this purpose where it was represented to be from the beneficial owner or where it was from a clearing organization (such as CEDEL or Euroclear), a bank or other financial organization (for example, a brokerage house) that in the ordinary course of its business holds customers' securities. A statement from a clearing organization, bank or financial institution would not have to identify the owner, but simply to state that the owner was

not a United States person. Withholding agents would not be entitled to rely on statements from a clearing organization, bank or financial organization if, in the period ending one month before the payment of interest, the Secretary had published a determination that statements from such a person, or class of such persons, were not acceptable.

Generally, the bill will not apply to interest paid to a controlled foreign corporation to or a holder of 10 percent or more of the issuer's voting stock or to a 10 percent or greater partner of the issuer. Such a person will therefore be subject to U.S. tax on interest otherwise covered by the bill, subject to any applicable tax treaty. However, the withholding agent will not be responsible for withholding on interest paid to controlled foreign corporations, and withholding will be required in respect of an interest paid to a 10 percent or greater stockholder or partner of the issuer only where the withholding agent knew, or had reason to know, that the interest was paid to such person. The elimination of withholding on interest paid to controlled foreign corporations, and the relaxed standard for withholding on interest paid to 10 percent or greater shareholders and partners, is necessary in order for these restrictions not to interfere with the effectiveness of the exemption provided by the bill.

A number of restrictions in the coverage of the bill (for example, the requirement of a statement of beneficial ownership) are intended to ensure that the exemption does not permit U.S. persons to avoid U.S. income tax. In addition, the Secretary is authorized to terminate the exemption, on a prospective basis, as to payments made to a foreign country when he determines that the exchange of information with that country is not adequate to prevent U.S. persons from avoiding U.S. tax on interest covered by the exemption.

The bill provides that the gross estate of a non-resident ailen decedent does not include an obligation, the interest on which is exempt from tax, and for this purpose eligibility for the exemption is determined without regard to whether a statement had been received that the obligation was beneficially owned by a foreign person.

DESCRIPTION OF THE BILL

Section 871(a)(1) and 882(a) of the Internal Revenue Code provide, respectively, for the imposition of a 30% tax on interest (including certain original issue discount) paid to nonresident alien individuals and foreign corporations. The bill would amend Section 871(a)(1) by adding a new paragraph (3) and would amend Section 882(a)(1) by adding a new subsection (c). New paragraph (3) and new subsection (c) would exempt nonresident alien individuals and foreign corporations from the 30 percent tax on interest (including original issue discount) on three classes of obligations:

> (1) obligations resulting from the assumption by a domestic corporation after the enactment of the bill of obligations issued prior thereto which, when issued, were guaranteed by a United States corporation and were sold directly or through underwriters, under arrangements reasonably designed to ensure that such obligations would be sold to persons who were not United States persons;
>
> (2) obligations which, when issued, were sold, directly or through underwriters, under arrangements reasonably designed to assure that such obligations would be sold only to persons who were not United States persons; and
>
> (3) obligations in registered form if the person who would otherwise be required to deduct and withhold tax under Section 1441(a) or Section 1442(a) has received a statement meeting the requirements of Section 871(g) to the effect that the person to whom the interest is paid is not a United States person.

In the case of obligations in the last two classes, the exemption in Section 882(c) would not apply if the interest was paid to a controlled foreign corporation; or if, in the case of interest paid by a partnership, the interest was paid to the holder of a 10 percent or greater capital or profits interest in the partnership; or if, in the case of interest paid by a corporation, the interest was paid to the holder of stock possessing 10 percent or more of the voting power of the corporation.

The bill adds a new Section 871(g) which defines the statement of ownership by a non-United States person that will be acceptable for the purpose of the exemption set forth in sections 871(a)(3)(C) and 882(c)(3). The statement need not identify the beneficial owner, but simply state that such owner is not a United States person. A statement will be acceptable if it is represented to be from the beneficial owner or is from securities' clearing organization (such as CEDEL or Eurodollar), a bank, or a financial institution (such as a brokerage house) that holds securities for customers in the ordinary course of its business. The Secretary may provide, on a prospective basis, that statements from specific clearing organizations, banks and financial organizations, or a class of such persons, are unacceptable.

The bill adds a new Section 871(h) which sets forth constructive ownership rules for the purposes of determining ownership of an issuer for the purposes of Sections 871(a)(3) and 882(c). These rules are, in general, the rules of paragraphs (2) through (5) of Section 318(a) except that the 50 percent limitation in Section 318(a)(2)(C) is eliminated and certain of the operating rules are modified.

The bill amends Section 864(c)(2) to eliminate interest covered by the exemption from the "force of attraction" rule.

The bill adds a new Section 898 which authorizes the Secretary to terminate the exemption in Sections 871(a)(3) and 882(c) as to payments of interest made to a foreign country where he determines that the exchange of information with that country is inadequate to prevent the evasion of the United States income tax by United States persons. Such termination will not apply to interest on obligations issued prior to the publication of such determination. It will continue until the Secretary has determined that the exchange of information is adequate to prevent the avoidance of the United States income tax by United States persons.

The bill amends Sections 1441(a) and 1442(a) to provide that no tax is to be deducted or withheld from interest (or original issue discount) covered by the exemption set forth in subparagraphs (A), (B) and (C) of Section 871(a)(3) or in paragraphs (1), (2) and (3) of Section 882(c) unless the withholding agent knows, or has reason to know, that the interest is taxable because paid to a 10 percent or greater shareholder or partner of the issuer. Thus, no withholding is required on interest paid to a controlled foreign corporation, although such corporation will be liable for U.S. tax on such interest subject to any applicable tax treaty exemption.

The bill amends Section 2105 to provide that the gross estate of a nonresident alien individual shall not include an obligation described in Section 871(a)(3) which, for this purpose, shall be applied as though there were no requirement that there be a statement that the obligation is beneficially owned by a person who is not a United States person.

The amendments made by the bill will apply to interest paid after the date of enactment except that the estate tax amendment of the bill will apply to estates of individuals dying after the date of enactment.

Mr. ROSTENKOWSKI. Mr. Hunter.

STATEMENT OF OAKLEY HUNTER, PRESIDENT AND CHAIRMAN OF THE BOARD, FEDERAL NATIONAL MORTGAGE ASSOCIATION

Mr. HUNTER. FNMA generally supports H.R. 7553 because we believe it is in the national interest. I speak today as Chairman of the Board and President of the Federal National Mortgage Association. I won't address the benefit to be gained by this legislation in reducing the balance-of-payments deficit; rather, I will merely speak to the point that this type of legislation will assist FNMA in fulfilling its basic purpose as set forth in its congressional charter which is to provide liquidity to the residential mortgage market; in other words, to help finance housing in this country.

FNMA is the largest single supplier of mortgage funds. Since FNMA came out of the Government in 1938, it has financed housing for some 3 million American families. Our portfolio at the present time stands at about $55 billion and we are active even in times as difficult as the present. For example, in the first 5 months of this year, through May 31, we purchased mortgages totaling over $5 billion, which represents financing for over 100,000 housing units.

Our financing this year in total—our debt financing—will probably run around $15 billion. FNMA is serving primarily the moderate income market. Our mortgages purchased last year averaged about $50,000. Of course, it is up from 1978. It has been progressively going up. But it still represents the moderate income market.

Since 1970, the corporation has been a stockholder-owned company, privately managed. We operate with our own funds. We pay full Federal corporate income taxes. As a matter of fact, one of our problems is that our effective tax rate is higher than any other long-term mortgage lender, but that is not to be discussed here. That will be discussed in connection with other legislation.

We raise our funds primarily through the sale of both short-term notes and debentures. We sell them in the capital markets in this country and on a limited basis abroad.

It is in the interest of the Federal National Mortgage Association and of the people of this country whom we serve that we have the broadest possible borrowing base, so that we can purchase mortgages at the lowest rates possible.

We definitely feel exempting interest paid to foreign owners of our debt securities will help in this regard.

In concluding I would like to emphasize that financing the needed housing of this country in the decade of the 1980's will not be an easy task because the aggregated demand for capital will be tremendous and permanent mortgage lenders are going to be hard pressed. Household formations will reach a peak in 1983 and will remain high for the rest of the 1980's as a result of a very high birth rate in earlier years. So there will be great pressures on the secondary residential mortgage market and that includes the Federal National Mortgage Association. I would say the same problem is faced by the Federal Home Loan Mortgage Corp. and by its parent the Federal Home Loan Bank Board, and the Home Loan Bank System, all of which have a similar interest in this legislation and I assume will be filing statements.

Mr. Chairman, that concludes my remarks. We appreciate very much this opportunity to appear.

Mr. ROSTENKOWSKI. Thank you, Mr. Hunter.

[The prepared statement follows:]

STATEMENT OF OAKLEY HUNTER, CHAIRMAN OF THE BOARD AND PRESIDENT, FEDERAL NATIONAL MORTGAGE ASSOCIATION

Mr. Chairman and Members of the Subcommittee, my name is Oakley Hunter. I am Chairman of the Board and President of the Federal National Mortgage Association (FNMA).

I appear here today to present FNMA's views on the proposed repeal of the withholding tax on interest paid to foreign lenders.

FNMA generally supports this type of legislation because we believe it is in the national interest. For example, it has the potential of helping in our continuing fight to reduce the balance of payments deficit.

Also, this type of legislation offers some help to FNMA in its meeting the increasing demand placed on it to provide needed liquidity when the residential mortgage market, as in the recent past, was buffeted by high costs and diminishing availability of mortgage funds.

This Subcommittee is generally aware of the manner in which FNMA, a Congressionally sponsored but stockholder owned and privately managed corporation, meets its statutory responsibility of providing liquidity to the secondary residential mortgage market. In other words, FNMA does only one thing—it buys and, as circumstances warrant, sells residential mortgages. As of May 31, 1980, FNMA had in portfolio $55.3 billion in residential mortgages. Since FNMA came out of government, it has financed housing for some 3 million families. Thus, it is clear that FNMA is a major source of housing credit.

FNMA's tax treatment is quite different from that of other residential mortgage lenders. Unlike thrift institutions and commercial banks, FNMA has no special statutory bad debt reserve deduction. The Federal Home Loan Mortgage Corporation, like FNMA, is a creature of the Congress and has the same Congressional mandate to assist the residential mortgage market. However, unlike FNMA, it is completely exempt from Federal corporate income tax. FNMA is the only large long-term residential mortgage investor that pays Federal corporate income tax at the full rate of 46 percent. Since 1969, FNMA has provided for the payment of almost $1.1 billion in Federal corporate income tax.

FNMA buys residential mortgages—those insured by the Federal Housing Administration, guaranteed by the Veterans Administration, and those which are conventionally financed. The mortgages we purchase are delivered pursuant to outstanding commitments to buy. These commitments are usually good for a four-month period and are sold competitively by FNMA to mortgage originators, such as mortgage bankers, savings and loan associations, mutual savings banks, commercial banks, etc. FNMA is then obligated to buy the residential mortgages that the mortgage originator delivers pursuant to those commitments. The mortgage originator, however, has the option of selling the mortgages to FNMA, retaining them for its own portfolio, or selling them to another investor.

FNMA obtains the funds necessary to buy mortgages through the sale of its own debt instruments. Our debt instruments include both short-term notes, which have a maturity of up to 360 days, and debentures, which on average have a maturity of less than four years. The bulk of our financing is through the issuance of debentures. As of May 31, 1980, FNMA had outstanding $7.74 billion in short-term notes and $44.83 billion in debentures. For the balance of this calendar year, FNMA has maturing almost $4.4 billion in debentures, which will have to be refinanced. In addition, between now and the end of this year, FNMA will have to raise at least several billion dollars to obtain the funds necessary to purchase the residential mortgages that will be delivered to us pursuant to outstanding commitments, which as of May 31, 1980 amounted to $4.1 billion.

It is, therefore, critical to FNMA's effective functioning that it have access to the widest possible range of credit and capital markets. To the extent that FNMA can attract funds from markets outside of the United States, such as the Eurodollar market, the burden of our financing activities will be eased. For example, according to Morgan Guaranty, the net size of the Eurodollar market as of mid-year 1979 was approximately $432 billion. The same source reports January through November, 1979 Eurobond issues denominated in U.S. dollars were $12.6 billion. It has been estimated by the Securities Industry Association that elimination of the withholding tax law would lead to an inflow of $5 to $7 billion into the U.S. fixed income market. Finally, reflecting in part the yield effects of the withholding tax, interest rates on bonds of foreign issuers traded in the U.S. appear to be somewhat higher than comparable issues trading in the Eurobond market.

Because of the withholding tax, the interest rate at which FNMA could borrow money abroad is not competitive with an essentially non-taxed marketplace.

The net interest yield on debt obligations is set without regard to the withholding tax. Obviously, the imposition of the withholding tax per se does not result in the collection of any revenue by the U.S. Government. What happens is that a foreign lender will not buy a debt instrument subject to the withholding tax; rather, he will seek out and invest in those instruments that are free of the withholding tax.

FNMA would seek foreign financing only when the interest rates on such financing would be attractive. When such a situation does arise, however, there would be substantial cost advantages to FNMA which, in turn, can be passed on to the home owners whose mortgages FNMA buys.

Let me now suggest a proposal under which FNMA would be able to tap the Eurodollar market, along with other U.S. corporations.

To permit FNMA to use overseas borrowings, we propose that the withholding tax be repealed on those bearer instruments that are designated for sale only outside of the United States to nonresident aliens and the underwriters clearly indicate their intentions to sell them only to such persons. In this manner, interest on the debentures can be set at a rate, which is fully competitive with other obligations sold in foreign markets.

However, we also support legislation that gives domestic corporations the option either of issuing such bonds or of issuing bonds that can be sold both in the United States and abroad.

Beyond the evidence as to the primary sale, the persons paying the interest should not be required to furnish any more information than persons paying interest on bearer instruments in the United States.

FNMA appreciates the opportunity of presenting its views to the Committee on this most important matter, and I will be pleased to answer your question.

Mr. ROSTENKOWSKI. Mr. McIntyre.

STATEMENT OF ROBERT S. McINTYRE, DIRECTOR, TAX REFORM RESEARCH GROUP

Mr. McINTYRE. Thank you, Mr. Chairman.

We appreciate the opportunity to be here to speak in opposition to this piece of legislation. As we understand, the supporters of this bill hope that by repealing the withholding tax the United States could become a major tax haven for international investors and the result of that would be to increase the supply of funds available for investment in the United States. We don't think this is a defensible goal for U.S. tax policy and we urge the subcommittee to reject the bill.

One thing should be made clear at the outset. That is that the withholding tax has little significance for most foreigners interested in investing in U.S. securities if they are not engaged in tax evasion in their own countries. We have treaties with most of our major trading partners which either eliminate or reduce the withholding tax. And even where the tax is applicable, it will generally result in a foreign tax credit for the foreign investors when they pay their domestic taxes. So the theory behind the bill—and it is summarized in a recent issue of Euromoney—is that foreign investors whose main interest is secrecy will be induced to invest here, whereas now they are deterred from doing it because under the rules that we have under our treaties, their home country would find out about this income.

Now, as the bill is drafted, that is, as passed by the Senate Finance Committee, it would not even achieve this result because there are disclosure requirements in the bill. So I assume most of the people on the panel with me would like to change those rules. Apparently they have worked things out with Treasury and Treasury now has a proposal essentially to allow the use of bearer bonds. There are some restrictions on U.S. citizens utilizing these bearer bonds, but I doubt the restrictions would work. The typical situation, if the U.S. citizens wanted to avoid the withholding tax or any tax by going abroad, would be to invest through a bank in a bank secrecy country, and it would be relatively easy to get involved in the kind of tax haven evasion we have seen in other areas already.

But ignoring that problem, we would still have the problem of becoming a haven for European tax evaders.

Secretary Lubick has taken the position that we should not be in the business of enforcing other countries' tax laws, just our own, which resembles very much the position taken recently by the Liechtenstein officials on "60 Minutes," in response to our complaints about their existence as a tax haven for our investors.

We think this position is just absolutely outrageous. It is a reversal of our traditional position against international tax evasion and in favor of full exchange of information among different countries.

Just about a year ago last April the Treasury and Justice Departments were here before the Oversight Subcommittee and testified at great length about our efforts to get more information about our taxpayers who were involved in tax havens abroad and how we were encouraging other countries to seek information from us about their taxpayers.

They said we would be using the treaty process to try to get more information. They said we might be using the withholding tax as leverage to get more information. This was the administration position about a year ago. Now, it appears that the administration is interested in helping our corporations tap the tax evader market abroad, and, even worse, that it is interested in tapping that market itself. They would like to be able to sell their bonds abroad and they have trouble now selling them to people who don't want to pay taxes in their own countries. But we don't think this country should be in the business of becoming a major tax haven.

There are several other reasons that we think this bill should not pass. It is not fair to American citizens who have to pay taxes on their interest, and who, in fact, if the administration is successful—and we support them in that effort—would have those taxes withheld. It also would be a windfall for foreign countries which would not have to grant foreign tax credits any more on the withholding taxes paid to the United States.

It also throws away a very useful treaty bargaining chip which as I noted, Treasury has promised to use in negotiating better information exchanges with foreign countries.

So finally in conclusion we think that this is not the kind of legislation that should be passed and it certainly is not the kind of legislation that the Treasury should be advocating. There is absolutely no question there is a huge problem worldwide with regard to tax evasion, and it is also clear that we are not going to solve it on our own. But the fact this situation does exist does not mean that we should be encouraging it, any more than the fact that the Bahamas lets Robert Vesco stay there means we should become a haven for international stock swindlers. That is not what this country is all about. We urge you to reject this bill.

We will be submitting written comments on some other bills before the committee which we hope you will have a chance to look at.

[The prepared statement follows:]

Public Citizen

Statement of
ROBERT S. McINTYRE
Director, Public Citizen's Tax Reform Research Group
Before the Subcommittee on Select Revenue Measures
Of the House Ways and Means Committee
Concerning H.R. 7553—A Bill to Repeal the
30% Withholding Tax on U.S. Portfolio Interest
Earned by Foreigners
June 19, 1980

Under this bill, which is actively supported by the Treasury, the 30% statutory withholding tax on portfolio interest earned by foreigners from U.S. sources would be repealed. Supporters of H.R. 7553 hope that its passage could result in the U.S. becoming a tax haven for foreign investors, and thereby increase the supply of investable funds in the United States. We do not believe this is a defensible goal for U.S. tax policy, and we urge the Subcommittee to reject the bill.

For most foreign investors in U.S. securities, the withholding tax has little or no impact —assuming the investors are not engaged in tax evasion in their home countries. By treaty, U.S. interest is exempt for citizens of Austria, Denmark, Finland, Germany, Greece, Hungary, Iceland, Ireland, Luxembourg, Malawi, Netherlands, Netherlands Antilles, Norway, Poland, Sweden, U.S.S.R., United Kingdom, and Zambia. Reciprocal rate reductions are provided under treaties with Belgium, Burundi, Canada, Rwanda, and Zaire (15%), Korea (12%), France, Japan, and Romania (10%), and Switzerland (5%). And even where withholding tax is due, it generally results in an offset against home country income taxes under standard foreign tax credit rules. Of course, to benefit from treaty exemptions or home country foreign tax credits, foreign investors must, directly or indirectly, make their U.S. interest income known to their own country's tax administrators.

What, then, is the theory underlying the contention that repeal of the withholding tax would increase foreign investment in the United States? The March 1980 issue of *Euromoney* provides a stark explanation: The withholding tax acts as a deterrent to foreign purchases of U.S. debt securities, the article states, "because many international investors desire secrecy and because the tax treaties do not, for example, extend to private investors in the Middle East." In other words, the hope of the advocates of this bill is that it would induce European tax evaders and oil-country sheiks to extend loans to American corporations.

In fact, as the bill is currently drafted, it could not achieve this result, even if the theory were correct. As *Euromoney* notes:

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> "[T]he bill's current language requires the Treasury to set up regulations that would disclose the final benefiting owner of the bonds, a rule that neither bars American ownership nor helps the marketability of the bonds among foreign buyers anxious to shelter themselves from their own tax burdens at home."

Since the avowed purpose of the bill is to provide an incentive to foreign tax evaders, *Euromoney* continues:

> "Wall Street, not surprisingly, is lobbying vigorously for excision of [the disclosure requirement], because it would wipe out almost all of the advantages to be gained from the removal of the withholding tax."

Given the Treasury's long-time commitment to international exchanges of tax information to counter tax evasion both here and abroad, it is not surprising that H.R. 7553 includes the ownership indentification provisions it does. But the disclosure requirements undercut the arguments in favor of the bill, and it now appears that Treasury's commitment to disclosure is weakening. *Euromoney* reports that Treasury is seeking alternatives to the disclosure rules, and quotes Assistant Secretary Donald Lubick as insisting: "We are not in the business of enforcing the tax laws of other countries, just our own." In fact, it appears, somewhat incredibly, that the Treasury itself, along with Fannie Mae and other federal entities, are interested in tapping the European tax evader market to sell their own notes.

We submit that this position is unconscionable and represents an outrageous reversal of the U.S.'s traditional position against tax evasion and in favor of full international exchange of tax information.

Just a year ago last April, at hearings on tax havens before the Ways and Means Oversight Subcommittee, administration officials reiterated their stand against international tax evasion and stated that "we are vitally interested in securing mutual assistance treaties which would enable us to exchange information with the foreign country, and to get some insight into the transactions of our citizens in the foreign countries."[1] Treasury's International Tax Counsel, David Rosenbloom, noted that "[o]ur official position is that a double tax convention should be used to require the exchange of all tax information."[2] As Joseph H. Guttentag of Arnold & Porter put it before the Oversight Subcommittee:

> "The United States has always supported the broadest type of information exchange. . . . The United States . . . needs all the information it can obtain to enforce its tax laws. . . . It is also in

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[1] Testimony of M. Carl Ferguson, Assistant Attorney General, Tax Division, Department of Justice, in Hearings before the Subcommittee on Oversight of the Committee on Ways and Means Concerning Offshore Tax Havens, 164 (April 1979) [hereinafter Tax Haven Hearings].

[2] Tax Haven Hearings, 272.

> the interest of the United States to provide information to other tax authorities to enable them to enforce their tax laws."[3]

In fact, at those hearings the administration supported improvements in the disclosure system to help assure that foreigners accurately indicate their home country when treaty exemptions are invoked.[4] As one witness at the hearing noted, "the United States has the right to expect friendly foreign governments to cooperate with us."[5] We should not squander that right by passing legislation designed to make the U.S. into a classic tax haven.[6]

There are a number of other reasons why H.R. 7553 should be rejected:

- It is unfair to American citizens, who *do* pay tax on their income from U.S. corporate bonds—and, if the administration is successful in another legislative proposal, would have taxes withheld on that interest.
- It would be a windfall for foreign countries, which no longer would have to grant foreign tax credits for withholding taxes paid to the U.S. The biggest beneficiary would be Canada, whose citizens currently pay almost 40% of the withholding tax, and which recently refused to negotiate a mutual reduction in the withholding rate.
- It would throw away a useful tax treaty bargaining chip, which could diminish our ability to obtain information about our own citizens' attempts to shelter income abroad. International Tax Counsel Rosenbloom promised the Oversight Subcommittee that we would make increasing use of such leverage in the future.[7]

In conclusion, we believe that it is an outrage that the Treasury should be before this Subcommittee advocating the passage of legislation which would make the United States a major tax haven for international investors. Certainly, there are problems in the existing world tax situation which make it difficult for the United States, on its own, to curb worldwide tax evasion. But that does not mean that we should countenance the use of our own country as a tax haven, any more than the fact that Argentina allows former Nazis to settle there means that we should become a haven for international war criminals. And it is even more outrageous for the Treasury and other government agencies to be seeking to *participate* in the international tax evasion market. The Congress overwhelmingly rejected the proposed repeal of the withholding tax when it was brought up in 1976. We urge the Subcommittee to repeat that action and reject H.R. 7553.

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[3] Tax Haven Hearings, 263.

[4] Testimony of H. David Rosenbloom, Tax Haven Hearings, 301–302.

[5] Testimony of Marshall J. Langer, Tax Haven Hearings, 228.

[6] Assistant Attorney General Ferguson defined a "tax haven" as "a nation which affords secrecy to investors and permits the accumulation of wealth without any significant tax burden." Tax Haven Hearings, 2. H.R. 7553 without the disclosure requirements would put the U.S. squarely within this definition.

[7] Tax Haven Hearings, 314–315.

Public Citizen

Statement of ROBERT S. McINTYRE
Director, PUBLIC CITIZEN'S TAX REFORM RESEARCH GROUP
Before the Subcommittee on Select Revenue Measures
of the House Ways and Means Committee
Concerning H.R. 4640 (The Houston Endowment), H.R. 5512
(The Moody Foundation), H.R. 4511 (Homeowners Associations),
H.R. 5847 (Port of Tampa IDBs), and H.R. 4175 (Masonic Lodges)
Hearing held on June 19, 1980
Statement filed on June 26, 1980

H.R. 4640. For the relief of the Houston Endowment.

The Houston Endowment of Houston, Texas, owns 100% of the stock of the corporation publishing the *Houston Chronicle*. It would like to continue to do so. The private foundation rules adopted in 1969, however, generally prohibit foundations from controlling private businesses. H.R. 4640 would provide an exemption from this restriction when the controlled private business is an independent newspaper. We believe that this exception is unwarranted, and urge that the bill be rejected.

The House and Senate Reports on the 1969 Tax Reform Act lay out the reasons for the restrictions on excess business holdings by private foundations. When a foundation controls a business, the reports note:

> "[T] here is a temptation for the foundation's managers to divert their attention to the maintenance and improvement of the business and away from their charitable duties. Where the charitable ownership predominates, the business may be run in a way which unfairly competes with other businesses whose owners must pay taxes on the income that they derive from the businesses. To deal with these problems, the committee has concluded that it is desirable to limit the extent to which a business may be controlled by a private foundation."
> S. Rept. No. 91–552 on H.R. 13270, 91st Cong., 1st Sess. 39 (1969); virtually identical statement in H. Rept. No. 91–413 (part 1) on H.R. 13270, 91st Cong., 1st Sess. 27 (1969).

What was the first example of such potential abuses to which the Senate Report points? None other than the Houston Endowment, whose 16 controlled corporations included "a

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large . . . metropolitan newspaper," that is, the *Houston Chronicle*! Thus, the situation for which H.R. 4640 would provide an exemption was exactly what Congress had in mind in passing the excess business holdings restrictions.

In 1972, Waldemar A. Nielsen wrote in *The Big Foundations* that, although the Houston Endowment:

> "is slowly becoming a more productive philanthropy, it is still heavily involved in business activities that distract from, if not conflict with, its philanthropic responsibilities. A conspicuous example is its ownership of the *Houston Chronicle*, now the only afternoon paper in a big, prosperous, and growing market."

Nielsen notes that the Endowment's trustees have taken an active interest in the paper's editorial policy, going so far as to force out an editor in the mid-60s when he deviated from their favored right-wing positions.

We believe that the fears about distraction from charitable purposes and unfair competition with taxable businesses which led to the enactment of the excess business holdings restrictions in 1969 are still valid today, and that they apply just as well to independent newspapers as to other business holdings. We urge that H.R. 4640 be rejected.

H.R. 5512. For the relief of the Moody Foundation.

Another restriction on private foundations in the 1969 Tax Reform Act prohibits self-dealing transactions between a private foundation and its managers, grantors, controlled corporations, and other "disqualified persons." The Moody Foundation of Galveston, Texas, would like an exception from this prohibition so that it can continue to rent office space in the Moody National Bank Building from the Moody National Bank, a corporation controlled by the Foundation and members of the Moody family.

The reasons for the prohibition against self-dealing—which replaced an approach mandating that transactions with related parties satisfy an "arm's-length" standard—are summarized in the House Report on the 1969 Tax Reform Act:

> "In order to minimize the need to apply subjective arm's-length standards, to avoid the temptation to misuse private foundations for non-charitable purposes, to provide a more rational relationship between sanctions and improper acts, and to make it more practical to properly enforce the law, your committee has determined to generally prohibit self-dealing transactions and to provide a variety and graduation of sanctions. . . ." H. Rept. No. 91—413 (Part 1) on H.R. 13270, 91st Cong., 1st Sess. 21 (1969).

The Senate Report contains virtually identical language, and then concludes:

> "The committee's decisions . . . are based upon the belief that the highest fiduciary standards require that self-dealing not be engaged in, rather than that arm's-length standards be observed."
> S. Rept. No. 91–552 on H.R. 13270, 91st Cong., 1st Sess. 29 (1969).

Through H.R. 5512, the Moody foundation seeks to have less than "the highest fiduciary standards" apply to its leasing of office space.

In 1972, the Moody Foundation was singled out in Waldemar A. Nielsen's *The Big Foundations* as a classic example of a poorly managed, scandal-ridden foundation.[1] The Foundation was set up by its grantor, says Nielsen, primarily for "the maintenance of family control over his properties and the avoidance of taxes." For at least its first 18 years of existence, its performance in charitable activities was, in Nielsen's words, "miserable." Family disputes resulted in both negligible charitable grants and declining asset values. In fact, in 1958, the Texas attorney general filed suit to reorganise the Foundation's management, arguing that under the prevailing circumstances the Foundation "could not operate for the benefit of the people of Texas." The suit resulted in a compromise with the family, which led to a temporary improvement in management, and during the early 60s the Foundation began to engage in some significant charitable activity. But in 1964, the new chairman of the board of the Foundation died, and, as Nielsen notes, "[T]he foundation again became stagnant." Since the passage of the '69 Tax Reform Act, charitable distributions have been at the legal minimum.

Two Moody grandsons, Shearn, Jr. and Robert, attempted to raid the fund's assets in 1968 by trying to push a special bill through the Texas legislature. This failed but further scandals continued. A committee of the Texas House of Representatives investigating foundations accused the Moody Foundation of corruption, conflict of interest, and self-dealing. Further charges were made in 1970 of inside deals with the Moody National Bank (the lessor of the building at issue with regard to H.R. 5512). Subsequently, the Foundation was accused of sweetheart deals with the Moody-controlled American National Insurance Company, which was itself charged with close ties to Las Vegas gambling interests and the mob.

In short, the Moody Foundation is exactly the kind of private foundation Congress had in mind in 1969 when it enacted the prohibition against self-dealing. Now, this foundation has the gall to come before this Subcommittee seeking relief from the restrictions so that it can continue to rent office space from the Moody National Bank.

There are two elements to the Foundation's argument, and each appears to be without merit.

First, it is maintained that the law works a hardship upon the Foundation because "[t]here is no available comparable space in a comparable building in Galveston to which the Foundation could move." In support of this seemingly preposterous claim, the Foundation offers letters from three Galveston real estate appraisers. The first, a Mr. Ross J. Novelli, is a building mate of the Foundation, maintaining his offices two flights down. His other

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[1] A copy of the section of Nielsen's book dealing with the Moody Foundation is attached.

Galveston clients include W. L. Moody and Company, Bankers; Shearn Moody, Jr. (mentioned above); the Moody-controlled American National Insurance Company; and (surprise!) the Moody National Bank. This disinterested observer assures the Foundation in his letter that he cannot find comparable "exclusive" office space for the Foundation anywhere in Galveston. There is, he notes, "one comparable quality building with comparable prestige offices, utility, and fitting the need to compare with that presently occupied by the Moody Foundation," but that building, unfortunately, is full. Other office space does exist, Mr. Novelli, admits, but "in much smaller size, [or?] much less prestigious."

The second appraiser consulted, a Mr. T. A. Waterman, also boasts of his other Moody clients, including the American National Insurance Company and the Moody Compress and Warehouse Company. He too laments that "[s] uch other office space as exists in this city is far below the quality of your present quarters." The third appraiser, a Mr. Jack Evans, does not list his qualifications or clients, but his statement—"I am not aware of any space meeting this criteria [sic] that is presently available"—speaks for itself.

These carefully hedged statements by appraisers with ties to other Moody enterprises, including the Moody National Bank itself, indicate, at most, only a possible shortage of gold-plated office space in Galveston. They offer virtually no support for the Foundation's argument that there is nowhere in Galveston it can go.

The second part of the Foundation's argument is that it can be trusted to comply with an arm's-length rule with regard to its lease with the Moody Bank, and that the fact that there are other tenants in the building will assist the IRS in auditing its lease arrangement. Based upon the real estate appraisers' assessments of the Foundation's current quarters—apparently the most "prestigious" available anywhere—it is not clear that even the other offices in the bank building are comparable. More important, the overlaps in management between the Foundation and the Bank make the possibility of real "arm's-length" dealings unlikely. For example, the Chairman of the Foundation's Board of Trustees is also the "Senior Chairman" of the Bank. Another Foundation trustee serves as the Bank's Chairman. The Executive Administrator of the Foundation is a Bank Director. Further links also exist between trustees, the Bank, and other Moody enterprises. As of December 31, 1976, the Foundation had a loan outstanding of over half a million dollars to W.L. Moody IV, a Director of the Bank and of several other Moody businesses. Given this congruity of management, and especially in light of previous charges of self-dealing between and the Foundation and the Bank, it would be folly to assume that arm's-length rules would be proper here.

Finally, it ought to be noted that the Foundation itself purchased the historic Santa Fe Building in Galveston in 1976, with the intent, according to the Foundation's 1976 annual report, that it "be restored and then leased to various government, charitable, research and education organizations." This building—"one of the biggest structures in town," according to the *Washington Star*, and situated in Galveston's hottest renovation area—would seem to be an ideal prospect as a location for the Foundation's offices.

In its report on the 1969 self-dealing restrictions, the Senate Finance Committee noted that if a disqualified person "owns an office building, the foundation should look elsewhere for its office space." S. Rept. No. 91–552 on H.R. 13270, 91st Cong., 1st Sess. 30 (1969). The Moody Foundation has had ten years to find itself new quarters. It is now past time that it did so. H.R. 5512 should be rejected.

H.R. 4511. Tax vote on non-exempt income of homeowners associations.

Under this bill, the tax on the income of homeowners associations derived from investments, conducting unrelated business activities, and non-exempt fees would be lowered from the current 46% rate to the graduated rates applicable to corporations, which start at 17% on the first $25,000 of income. We believe that such a change would provide an unwarranted opportunity for tax avoidance on the part of the members of such associations, and we urge the Subcommittee to reject the bill.

In its statement opposing the bill, the Treasury speaks of the dangers of homeowners contributing portfolio assets to an association or using an association as a shield for unrelated business income. These are indeed real possibilities in some circumstances. But even where association members have no choate tax avoidance purpose, applying the graduated corporate rates to non-exempt association income would frequently result in an unfair tax advantage for the members. This is because the association's tax rate on reserve fund interest (or other non-exempt income) would typically be less than the rate which would be paid by the members if the income were attributed to them or if they had first earned the income and then contributed it to defray repair costs.

In granting homeowner associations tax-exempt status on dues in 1976, Congress was careful to avoid the establishment of a new tax shelter opportunity. Contrary to the assertion of the proponents of H.R. 4511 that applying the 46% corporate rate to reserve fund interest is somehow inconsistent with the purposes of section 528, Congress quite intentionally and properly provided that such income was to be so taxed. As the Senate Report on the 1976 Tax Reform Act specifically states: "[A]ny interest earned on amounts set aside in a sinking fund for improvements is taxable.... The tax rate to be applied is the corporate rate without the surtax exemption." S. Rept. No. 94–938 on H.R. 10612, 94th Cong., 2d Sess. 394-95 (1976). The rationale for the taxing scheme is also laid out clearly in the Senate Report:

> "[T]he committee believes it is not appropriate to tax the revenues of an association of homeowners who act together if an individual homeowner acting alone would not be taxed on the same activity. . . . [On the other hand,] under the com-

> mittee amendment an association's net investment income, and net trade or business income, *is* to be taxable, since an individual homeowner *would* be similarly taxed on investment income, such as interest earned on money set aside for improvements." [Emphasis added.] *Id.* 394.

In 1978, when the corporate rates were graduated, Congress reaffirmed its decision to tax the non-exempt income of homeowner associations at the top corporate rate. Absent conduit treatment, current law provides the fairest treatment for non-exempt homeowner association income. We recommend that H.R. 4511 be rejected.

H.R. 5847. Industrial development bond financing to refinance existing, conventionally financed dock facilities in the Port of Tampa, Florida.

This bill would allow the use of tax-free bonds to refinance the debt on already existing structures and land owned by the Agrico Chemical Company in the Port of Tampa. (The property is currently financed conventionally.) We oppose the bill.

Tax-free financing is a notoriously inefficient means of providing a federal subsidy to state and local borrowing, whether for governmental purposes or for assistance to business development. The reason—simply put—is that the federal government loses more in tax revenues than the state or municipality (or private corporation) saves in interest reductions. The use of such bonds also reduces tax equity, since the difference between the federal cost and the interest savings results in windfall tax reductions for wealthy investors.

We therefore are generally opposed to any expansion in the use of tax-exempt bonds. Even if Congress is relatively unconcerned about the waste which tax-exempt financing entails, however, the situation to which H.R. 5857 applies seems to be a singularly inappropriate one to provide a further exception from the restrictions on industrial development bonds. This is because the proceeds of the bonds at issue would not even result in new construction.

The Tampa Port Authority, of course, has no reservations about lending its tax exemption to Agrico Chemical Company in order to accomplish the tax-exempt refinancing of the dock facilities. Why should it, since the cost will be borne by the Treasury and federal taxpayers? But this Subcommittee *does* have the responsibility to see that federal tax subsidies are not granted wastefully. We urge that H.R. 5847 be rejected.

H.R. 4175. Tax deductions for building fund contributions to Masonic lodges and certain other fraternal organizations.

This bill would allow a tax deduction for gifts to fraternal organizations tax-exempt under IRC Section 501(c)(10)[2] if the funds are used for the construction or maintenance of buildings housing such organizations. The primary beneficiaries would apparently be members of Masonic lodges,[3] which constitute about 90% of the 501(c)(10) organizations.

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[2] IRC Section 501(c)(10) applies to "Domestic fraternal societies, orders, or associations, operating under the lodge system—

> "(A) the net earnings of which are devoted exclusively to religious, charitable, scientific, literary, educational, and fraternal purposes, and
>
> "(B) which do not provide for the payment of life, sick, accident, or other benefits."

Individual contributions to Masonic lodges are already tax deductible under IRC Section 170(c)(4), so long as the donations are earmarked "exclusively for religious, charitable, scientific, litereary, or educational purposes, or for the prevention of cruelty to children or animals." Masonic lodge *buildings*, however, are utilized only in part for a group's charitable purposes. Other functions usually carried out in the lodge building include entertainment, planning parades, and fellowship meetings.[4] Thus, under current law, contributions to a lodge's building or maintenance fund are not tax deductible, and the IRS so ruled in 1956. *Rev. Rul. 56–329.*

H.R. 4175 would reverse this ruling so as to allow deductibility. We believe this result would be seriously inconsistent with the accepted rationales for the deductibility of charitable gifts, and we urge that the bill be rejected.

When the charitable deduction was first established in 1917, its stated purpose was to provide a non-intrusive government subsidy to organizations performing functions that served the public good—functions that the government itself might have to supply if the charitable organizations did not exist.[5] Some tax theorists assert in additional support of the deduction that funds (or property) transferred to charities do not constitute either personal consumption or savings on the part of the donor, and therefore should not be part of the *income* tax base under the most common theoretical definition of income. The non-religious charitable deduction has therefore been generally limited to contributions used "exclusively for charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals,"[6] activities which benefit the public at large rather than the donor and are often also directly subsidized by the government.

We believe this limitation is wise tax policy, and that an exception should not be made for the Masons. Not only would such an exception be intrinsically wrong, but, like the depletion allowance, it would be likely to expand greatly in the future, as other groups queued up for similar favors.[7] We urge that H.R. 4175 not be favorably reported.

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[3] Masonic lodges are associations of males, dedicated to the improvement of morals and character through fellowship, mutual helpfulness, and symbolic rituals. *See, e.g.*, Blackmer, *The Lodge and the Craft* (1976), p. 11, 15; Hammond, *What Masonry Means* (1975), p. 15.

[4] *See, e.g.*, Blackmer, *supra*, p. 259.

[5] The deductibility of religious contributions is, of course, not defensible under this rationale. It is usually justified as the best way for the government to avoid "entanglement" with religious organizations, in compliance with the first amendment.

[6] In certain cases, contributions to organizations established to foster amateur sports, to non-profit cemetery companies, and to veterans posts are also deductible.

[7] The next most likely candidates would be the Elks and the Moose, tax-exempt under Section 501(c)(8), rather than 501(c)(10), because they provide insurance benefits to members.

THE BIG FOUNDATIONS

Waldemar A. Nielsen

A TWENTIETH CENTURY FUND STUDY

New York and London
COLUMBIA UNIVERSITY PRESS / 1972

9.

Texas: Rich Land, Poor Land Moody, Houston, Richardson, and Brown

TEXAS IS A STATE with a unique political and economic history, a special ethos, and its own mythology. It also claims a separate chapter in the story of American philanthropy.

Until the turn of the century, Texas had been little more than a vast, impoverished rural expanse. But after 1901, when the Spindletop oil gusher blew in at Beaumont, it began a spectacular economic development. For the next forty years its economy was centered on raw materials—principally cotton and beef and oil and natural gas—which it exported to other more advanced states for final processing. After World War II, Texas began to develop industrially, first in petrochemicals and later in electronics and aerospace technology. This in turn led to accelerated urbanization, particularly along the Gulf Coast, and to a huge, sustained real estate boom.

Despite its reputation for riches and the legend of the "Texas millionaire," however, it has long been a poor state. The income of the average family until recently was well below the national average. Texas also continues to be dominated politically by rural interests, and culturally by that form of the frontier spirit in which personal goals are material rather than civic, and the acquisition of wealth and power takes precedence over esthetics and social reform. That spirit is steadily being eroded. But its memory has not vanished, particularly in the field of business.

In the brutality of the economic struggle in Texas, those who had the courage, the competence, or the luck to win, won heavily; and their fortunes, in many cases, have now been bequeathed to foundations. The four created thus far that have more than $100 million in assets each are the Moody Foundation of Galveston, the Houston Endowment and the Brown Foundation of Houston, and the Sid W. Richardson Foundation of Fort Worth.

The Moody Foundation

William L. Moody Jr., donor of the Moody Foundation, inherited from his father, Colonel William L. Moody, a successful cotton-trading firm, which by compulsive dedication to hard work he built into a diversified empire. When he died in 1954, at the age of eighty-nine, it was valued at more than $400 million. Among his holdings were the American National Insurance Company, the Moody National Bank of Galveston, three newspapers, a chain of hotels, extensive ranchland, and numerous oil and mineral properties.

He was a tall, slender man, taciturn in manner. With his small gray mustache and neat appearance, he resembled an elderly bookkeeper, and it always amused him to be mistaken for one. In business circles, though, he was known to be "tighter than the paper on the wall" and "meaner than a bullwhip." To his employees, he was a tireless and tyrannical taskmaster. He labored at his desk seven days a week, often sixteen hours a day. Appropriately, he was working in his insurance company office the day he died.

Apart from making money, almost his only other interest was duck hunting. His civic impulses were minimal. There are many in Galveston who believe that his steadfast opposition to any bond issues or expenditures for the improvement of the city largely explains why its development lagged badly behind that of neighboring Houston. Some also believe that Galveston's reputation as a "sin city" derives in good part from Moody's encouragement of gambling and other unpuritanical activities on grounds that they were good for his hotel business.

William Moody created his foundation in August 1942, twelve years before his death. The terms of his trust indenture make obvious that his primary concerns at the time were the maintenance of family control over his properties and the avoidance of taxes. His trustees were instructed to administer his gifts strictly in accordance with conditions he set forth. The corpus of the trust was to be kept intact and the income was to be applied to religious, charitable, scientific, and educational purposes within the state of Texas.*

When Mrs. Moody died in 1943 the assets of the foundation were substantially increased. Various members of the family were given a life interest in the income of her Libbie Shearn Moody Trust, but three-quarters of its assets were earmarked to revert eventually to the foundation. The remainder was designated for the Methodist Church, of which she was a devout member. The assets of the trust in 1968 were valued at $157 million, by which time the foundation had purchased more than half of the income interests of the family members with lump-sum payments from capital.

When Moody died, he left the bulk of his wealth, consisting of his numerous business enterprises, to the foundation. But most of them, because of his monarchical methods of management, lacked an effective executive structure and their profits quickly sagged. (As of 1968, the foundation's assets were valued at $191 million, a dramatic decrease from their reported worth a decade earlier. Their value has since dropped still further.) In addition, a succession of bitter legal disputes among members of the Moody family, who were also trustees of the foundation, immediately erupted. Mr. and Mrs. Moody had two sons and two daughters, and family strife was not unknown to them. The older son, W. L. Moody 3d, had worked with his father in running the family businesses, but broke with him in the 1920s. They came together again in the 1940s, but frictions again developed and they separated definitely in 1950. In his will, the father left William one dollar, which now hangs framed in his office in San Antonio, Texas.*

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* At the time, Texas law (Article 7112, Ch. V, Revised Civil Statutes of 1925) provided that inheritance tax would not be applied to property passing to or for the use of "any religious, educational, or charitable organization, when such bequests were to be used within the state of Texas." If such property were transferred outside of Texas, an inheritance tax rate of up to 20 percent was to be applied depending upon the size of the estate. Since 1965, the Texas legislature has removed bequests to tax-exempt foundations from taxation even if they are located outside Texas and the funds are used outside the state.

Shearn, the second son, died in 1936. His two sons, Shearn Jr. and Robert, after their grandfather's death, sought to break his will by court action, charging that he had robbed them of their proper share of the family fortune. The suit outraged their aunt, Mary Moody Northen (Moody's elder daughter), and split the family trustees of the foundation into two warring groups. In her lifelong devotion to her father and his memory, the childless Aunt Mary resembles a character out of a nineteenth-century novel. After her mother's death, she spent every night in her father's thirty-room house, staying awake in his chair on the ground floor until he arose at daybreak, when she would return to her own house to sleep. After he died she moved into the big house and simultaneously assumed his place as head of the family companies and the foundation.

The rupture produced by the lawsuit of the two grandsons paralyzed the foundation for four years. The trustees in that period could not even agree on a date for a board meeting.† Finally, in 1958, the Texas attorney-general, Will Wilson, felt obliged to intervene. Filing suit in the 122d District Court of Texas, he argued that under the prevailing circumstances the foundation "could not operate for the benefit of the people of Texas" and asked the court to increase the number of trustees from the four relatives then composing it to "nine or such other odd number as the court may deem proper." He requested that the new trustees not be members of the family or related to any of the Moody enterprises.[1]

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* In reply to a note from his father in 1950 suggesting he resign from the company, William wrote: "I have hoped that I came into this world happily for you, but whether or not, my heart beats with your blood. . . . I had hoped with all my heart, as we both grew older and you much more successful, that small but honest differences would appear as trivial as they are, and that the years and better understanding would . . . strengthen the ties of affection and loyalty which should exist between father and son and son and father." The father was unmoved and fired him. (*Fortune*, March 1971, p. 112)

† During this time a close associate of the family and the foundation became so troubled by possible tax problems and legal violations that he visited the Ford Foundation in New York to ask whether it would be willing to take over the tangled affairs of the Moody Foundation. The offer was declined.

The threat of being ousted from control of their companies and the foundation caused the quarreling relatives to compose their differences, at least temporarily, and to work out a compromise settlement with the state. Mary Moody Northen agreed to step down as president of the various businesses, cash settlements were agreed upon with the two grandsons, and three new independent trustees were named to the foundation's board. Because the family proposed three individuals of high standing—Sales Leach, a retired executive of the Texaco Company; Marcus Greer, a Houston banker; and James M. Lykes Jr., head of a large Texas shipping company—the attorney-general did not insist on his own appointees. It was further agreed that no trustee of the foundation could be a paid officer of any company owned by it or the family and that the controlled companies would institute dividend policies sufficient to enable the foundation to carry out a program of "normal" size.

Final agreement with the Texas authorities was reached in April 1959, and for the next few years some progress was made. Leach became chairman of the board and worked diligently to halt the deterioration of the Moody companies and to activate the foundation. But he died in 1964 and the foundation once again became stagnant. Paul R. Haas, a wealthy San Antonio investor who was named to succeed Leach, found his difficulties sharply increased when the two grandsons attempted to raid the assets of the foundation in the spring of 1968—this time by legislative rather than judicial proceedings.[*] They arranged to have a special bill introduced into the Texas legislature that would have changed Texas law to permit stock dividends of any company to be considered as income for beneficiaries of a trust rather than as accretions to the corpus.

This technical change, given the relationship of the Moody

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[*] At the time Shearn Jr. issued a press release describing himself in the third person as "a world traveler, art patron, and a well-rounded individual of many interests. His palm-studded ranch home on Galveston Island is a show place—filled with tapestries, paintings, imported rugs, and other *objets d'art*. He has contributed generously, for many years, to the civic opera companies of San Antonio, Houston, and Dallas, to name just a few."

Foundation to the associated Libbie Shearn Moody Trust, would have resulted in the transfer of as much as $30 million of the assets of the trust to the two grandsons and would have put the foundation at a disadvantage in the event of future stock dividends by the foundation-controlled American National Insurance Company. To fulfill their obligations to the foundation, the nonfamily trustees fought the so-called "Moody bill," and it was defeated.

A few months later, fresh disputes and scandal erupted. Witnesses before a committee of the Texas House of Representatives investigating foundations accused the Moody Foundation and some of its associated companies of corruption, conflict of interest, and self-dealing. On October 11, 1970, Roy Cohn, one-time counsel to the late Senator Joseph R. McCarthy, charged the foundation with making an "inside deal" with Carey Mayfield, head of the foundation-controlled Moody National Bank, to buy a chain of hotels owned by the foundation at a giveaway price. Cohn's client, New York investor Laurence Hurwitz, had reportedly made a bid substantially higher than Mayfield's, but it was rejected. The foundation's claim of innocence was not strengthened when, six days after the storm broke, it announced that the proposed sale to Mayfield had been canceled and that bidding was being reopened.

Subsequently, a former general agent of the American National Insurance Company, Norman Revie, claimed that the foundation had been bilked out of income by the company's practice of keeping a huge noninterest-bearing cash deposit in the First City National Bank of Houston, headed by Moody Foundation trustee S. Marcus Greer. He also charged that the insurance company directly supported by mortgage loans at least half of all the gambling casinos in Las Vegas and the Bahamas. He stated that two former officers of the insurance company had richly profited from these mortgage and lending transactions, many of which were arranged through a Morris Shenker of St. Louis, described by *Life* magazine as "the foremost lawyer for the mob in the United States."[2]

In the same period, Shearn Moody Jr., undaunted by his earlier defeats in the courts and legislature, made still another attack on the foundation. He filed suit to block a proposed increase in the size of its board from seven to nine and challenged the legality of the membership of the three nonfamily trustees. With Roy Cohn and young Shearn Moody simultaneously on the attack, the foundation was caught between the malodorous and the disreputable and was beginning to look rather soiled itself from the dirt being thrown.[3]

ONWARD AND UPWARD, SLIGHTLY

The Moody Foundation has now existed nearly thirty years, and its performance for at least two-thirds of that period has been miserable. Its only significant grant until the 1950s was one of $246,000 to a school for cerebral-palsied children. From 1954 to 1960, while it was enmeshed in family quarrels and litigation, it received little income from its controlled companies and dispensed almost nothing in grants. From 1960, when nonfamily members were added to the board, until 1965 the foundation went through its first period of real philanthropic activity. Until 1960 it had dispensed less than $400,000 in total grants, but between then and 1965 it gave $25 million, largely in the form of lump-sum contributions to colleges, hospitals, and welfare organizations. By 1965 it had acquired its first full-time professional staff member and had issued its first public report.

According to its annual report for 1969, outlays to that point had reached a total of $34.2 million, broken down as follows:

	Percent
Education	53.6
Health	13.6
Welfare	12.0
Humanities	10.6
Religion	8.6
Scientific research	1.6
Total	100.0

In each category the grants were almost entirely for buildings, equipment, or general support. But in the 1969 list, there were some indications of a slightly changing approach: $160,800 to the

Moody Scholars Program for high-school seniors to help finance their college education; $30,000 to the Mission Information on Drugs and Narcotics Project for the printing and distribution of pamphlets to high-school students; and $37,500 to the Corpus Christi Symphony Orchestra. As of 1970 the Moody Foundation had eliminated an earlier accumulation-of-income problem by a series of lump-sum grants and had reached a significant level of current income on investments and of annual grant distributions. It had succeeded also in defining some program objectives and in beginning a planning process for the future. Public reports were being issued, and the trustees had taken initial action to sell some of the companies controlled by the foundation and to diversify its portfolio. But four-fifths of the assets were still in American National Insurance Company stock and an even higher proportion of those of the Libbie Shearn Moody Trust were in shares of the same company.

That the Moody Foundation has made any progress at all is a tribute to the initiative of the Texas attorney-general, the courts of the state, and the willingness of the nonfamily members of the board to undertake the difficult task of extricating the institution from a morass of legal, financial, and managerial problems in the face of unremitting personal antagonism from family members.

The Houston Endowment

Jesse H. Jones, the donor of the Houston Endowment, lived in the same economic era as William Moody but was a much bigger person in every sense. A self-made man of imposing physical stature, he was the indisputable "Mr. Houston." More than any other individual in its history, he led the city's growth and shaped its development.

Born in Tennessee, he settled in Houston early in the century and began his career as a builder and real estate operator. By 1910 he owned more than a dozen hotels and office buildings and was buying others. Although he was not primarily an oilman, he

Mr. ROSTENKOWSKI. Mr. Groom.

STATEMENT OF THEODORE R. GROOM, COUNSEL, ON BEHALF OF AETNA LIFE & CASUALTY, CONNECTICUT GENERAL LIFE INSURANCE CO., THE EQUITABLE LIFE ASSURANCE SOCIETY OF THE UNITED STATES, JOHN HANCOCK MUTUAL LIFE INSURANCE CO., METROPOLITAN LIFE INSURANCE CO., PHOENIX MUTUAL LIFE INSURANCE CO., THE PRUDENTIAL INSURANCE CO. OF AMERICA, AND THE TRAVELERS

Mr. GROOM. My name is Theodore R. Groom. I am a member of the Washington, D.C. law firm of Groom & Nordberg. I appear today on behalf of eight major U.S. life insurance companies: Aetna Life & Casualty, Connecticut General Life Insurance Co., the Equitable Life Insurance Co., Metropolitan Life Insurance Co., Phoenix Mutual Life Insurance Co., the Prudential Insurance Co. of America, and the Travelers.

The subject of our testimony is a proposal which, like H.R. 7553, the interest withholding exemption proposal before the subcommittee, is primarily designed to attract increased foreign capital to the United States by removing withholding taxes. Specifically, we are proposing amendments to the tax laws that would allow life insurance companies, banks and other U.S. financial intermediaries to invest the assets of foreign pension funds in the United States on a nontaxable basis.

For many years, particularly recently, we have had a lot of interest expressed by foreign retirement plans, particularly in Japan, Netherlands and the United Kingdom, in placing their funds for investment in the United States. However, under current U.S. tax laws, there is a substantial disincentive for them to do so because they are subject to withholding taxes. If the foreign retirement plan, for example, pays its money to Prudential, and Prudential invests its money for it and then pays it back to the foreign retirement plan, the withholding tax is applicable. There is also a more specialized problem of U.S. life insurance company taxation that ends up producing a capital gains tax.

While we support the general bill, H.R. 7553, and do not agree with the comments that the previous witness has made, I would like to point out that our proposal is not susceptible to the types of criticisms offered by the previous witness. For example, what we are proposing is a provision for no U.S. tax on investment in the United States by a foreign retirement plan which, if it were a U.S. retirement plan, would not be subject to tax.

I believe the gentleman before me pointed out or was alleging that there might be some tax evasion involved here. However, we are talking about the ability of U.S. financial institutions to handle moneys of retirement plans that would be tax exempt in their own country and, indeed, if they were a U.S. retirement plan, would be tax exempt here.

So that there is also the feature in our particular proposal that we are not suggesting that the foreign entity be taxed more favorably than his counterpart in the United States is. We are in effect suggesting the same type of treatment for both the foreign retirement plan as that which is afforded to U.S. retirement plans.

But it is in common with the more general proposal before the subcommittee that it would attract additional investment to the United States.

Thank you very much.

[The proposed statement follows:]

STATEMENT OF THEODORE R. GROOM, ON BEHALF OF AETNA LIFE & CASUALTY, CONNECTICUT GENERAL LIFE INSURANCE CO., THE EQUITABLE LIFE ASSURANCE SOCIETY OF THE UNITED STATES, JOHN HANCOCK MUTUAL LIFE INSURANCE CO., METROPOLITAN LIFE INSURANCE CO., PHOENIX MUTUAL LIFE INSURANCE CO., THE PRUDENTIAL INSURANCE COMPANY OF AMERICA, AND THE TRAVELERS

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The subject of our testimony is a proposal which, like H.R. 7553, the interest withholding exemption proposal before the Subcommittee, is primarily designed to attract increased foreign capital to the United States by removing withholding taxes. Specifically, we are proposing amendments to the tax laws that would allow life insurance companies, banks and other U.S. financial intermediaries to invest the assets of foreign pension funds in the United States on a non-taxable basis.

SUMMARY

In recent years, managers of foreign pension funds maintained by major employers in industrialized foreign countries, including the United Kingdom, the Netherlands and Japan, have shown a strong interest in investing in the United States. While the opportunity to earn attractive investment returns has been a factor in this movement, managers of foreign pension funds have also viewed U.S. investment as an important means of diversifying their portfolios and lessening their pension funds' dependence on the economic cycles of their home countries.

Foreign pension funds represent a potentially substantial source of additional capital for the United States. However, current U.S. tax laws and treaties do not encourage foreign pension funds to invest here. Generally, foreign pension funds will be subject to the same tax burdens, primarily withholding taxes, as other foreign portfolio investors. This is the case even though U.S. pension funds are exempt from tax on their U.S. investment income, and even though foreign pension funds are exempt from income taxes in their home countries. Further, to the extent that foreign pension funds have made some U.S. investments, the structure of the Code provisions for the taxation of life insurance companies has discouraged foreign pension funds from utilizing life insurance company pension funding arrangements for this purpose relative to those offered by other U.S. financial intermediaries.

Our proposal would equalize the U.S. tax treatment of U.S. investment income earned by domestic and foreign pension funds, and would eliminate impediments of present law to foreign pension fund investments through life insurance companies. We believe its enactment would increase the benefits the U.S. economy generally derives from foreign investment at a negligible or zero revenue loss.

PROBLEMS UNDER PRESENT LAW

For many years, the tax laws have provided an exemption from U.S. tax for the investment income and gains of "tax-qualified" pension trusts and similar retirement funds. These provisions allow a U.S. financial intermediary to receive funds from a domestic pension fund, invest them and ultimately repay the principal and accumulated investment income to the pension fund without the imposition of any U.S. tax. The U.S. life insurance industry currently holds more than $100 billion of the more than $300 billion in assets now held under such tax-favored retirement arrangements.

In general, a basic policy of U.S. tax law has been to provide for equal treatment of comparable types of U.S. and foreign investors. This policy, however, is not carried out in the case of pension funds. This is because the applicability of the statutory tax exemption for pension funds (secs. 401(a), 501(a) of the Code) requires compliance with detailed qualification requirements which largely reflect U.S. retirement income policies toward U.S. workers. Foreign pension funds will rarely be in a position to conform with these highly complex requirements many of which reflect policies that may be irrelevant to foreign pension funds and may even conflict with the retirement plan laws of their home countries. Even if a foreign pension fund made an attempt to satisfy the U.S. qualification requirements, compliance would be difficult to establish unless the fund obtained an IRS determination letter to that effect—a step which foreign pension funds are unlikely to take. Significantly, these problems do not arise in the case of foreign charitable or religious organizations. Foreign charitable or religious organizations may qualify under the broad U.S. standards for such organizations (sec. 501(c)(3)) without much difficulty, and, thus, would be exempt from U.S. income and withholding taxes on their passive investment income under present law.

As a practical matter then, current law subjects foreign pension funds to the same tax rules that apply to individual and corporate foreign investors generally. This means that dividends, rents and most forms of interest and other investment income, except for capital gains, will be subject to the 30 percent withholding tax unless a lower rate applies under a tax treaty. Of course, such funds also may be able to avail themselves of tax planning mechanisms presently available to foreign investors generally.

In addition to withholding taxes, a foreign pension fund that invented in the U.S. through a life insurance company would, at least indirectly, be subject to tax on its U.S. capital gains. This problem—which is not shared by banks, mutual funds and others—occurs because the life insurance company tax rules are structured to allow insurers to invest funds on a tax-free basis only for specified tax-qualified retirement arrangements (secs. 801(g)(7) and 805(d) of the Code).

PROPOSED SOLUTION

Our proposal would resolve these problems by allowing U.S. financial intermediaries to invest the assets of foreign pension funds in the United States on a non-taxable basis and without the imposition of withholding taxes on income subsequently paid to such funds. In our view, this proposal should, consistent with sound tax policy considerations, increase U.S. investments by foreign pension funds and produce significant benefits to the economy. Specifically:

1. The proposal would channel new foreign capital to domestic financial intermediaries who are major sources of U.S. business financing. In this regard, since pension fund investments are ordinarily made on a long-term basis, investments made by foreign pension funds under the proposal are likely to be more stable than some other forms of foreign investment.

2. The proposal would be limited to bona fide retirement funds which are tax-favored in their home countries. Thus, any resulting U.S. tax savings should not have the effect of increasing foreign tax payments.

3. The proposal is limited to pension fund portfolio investments with respect to which U.S.-managed financial institutions make the actual investment decisions. Consequently, foreign pension fund investors would not be in a position to exercise control or otherwise influence U.S. businesses.

4. The proposal would extend to foreign pension funds the same tax treatment as their U.S. counterparts with respect to the taxation of U.S. source investment income and gains. Further, foreign pension funds would be able to select appropriate financial intermediaries for their U.S. investments without regard to the particular U.S. tax rules that may apply at the financial intermediary level.

5. Little or no revenue loss should be involved. To the extent that foreign pension funds have or may make substantial U.S. investments on a taxable basis, it is likely that such investments are or would be structured so as to minimize U.S. tax burdens.

We urge the Subcommittee to adopt our proposal in connection which its consideration of the proposal to eliminate withholding taxes on interest paid to foreign portfolio investors. We sincerely appreciate this opportunity to appear before the Subcommittee.

Mr. ROSTENKOWSKI. Thank you. Mr. Gore.

STATEMENT OF CARTER GORE, DIRECTOR, TAX LEGAL DIVISION, NATIONAL FOREIGN TRADE COUNCIL, INC.

Mr. Gore. I am Carter Gore, and I am testifying on behalf of the National Foreign Trade Council, a nonprofit organization, whose membership comprises a broad cross-section of over 600 U.S. companies with highly diversified interests engaged in all aspects of international trade and investment.

We support the repeal of the 30-percent withholding tax on interest paid to foreign investors on portfolio indebtedness. This tax makes investment in U.S. securities unattractive to foreign lenders.

To obtain foreign funds, the U.S. borrower must agree to reimburse the tax, which makes the cost of borrowing from foreign sources prohibitive. While some tax treaties reduce the 30-percent rate, individual foreign investors must comply with burdensome refund procedures which frequently result in costly delays in obtaining a partial refund of the withholding tax.

Some foreign investment is currently being made in U.S. debt securities through finance subsidiaries of U.S. corporations incorporated in the Netherlands Antilles. We believe it is undesirable to foster a situation where such corporations are created and maintained to avoid the withholding tax. Repeal of the withholding tax would make such financing vehicles, which are generally available to only large investors, unnecessary.

The council believes that elimination of the withholding tax on interest paid to foreign portfolio investors would make the debt securities market in the United States more attractive to foreign investors. The additional investment in U.S. debt securities by foreign investors resulting in increased inflows will, we believe, improve our balance-of-payments position and possibly strengthen the dollar.

Of course, a number of other factors, such as comparative yields, inflation rates, and funds available for investment, could affect the magnitude of that inflow.

A critical fact, we believe, is that the United States needs additional capital for new investment in plant and equipment, which, in turn, would increase productivity and reduce inflation. Continuation of the withholding tax on interest could keep substantial amounts of foreign private capital out of the U.S. bond markets.

The long-term revenue gains from taxes on profits, wages, and dividends generated by the additional investment along with the reduction in foreign tax credits claimed for taxes paid to the Netherlands Antilles by financing subsidiaries should more than offset a revenue loss estimated to be in the magnitude of $30 to $40 million annually.

Foreign holders of discount debt instruments with an original maturity of 6 months or less currently enjoy exemption from withholding. Extending the exemption to long-term instruments would contribute to a significant improvement of the liquidity of the U.S. foreign investment position.

U.S. external assets are predominantly direct investments which is long-term in nature. By contrast, our external liabilities consist primarily of short-term debt. Any lengthening of maturities is, therefore, desirable since it would reduce the potential capital outflow when short-term interest rates decline relative to returns available in the

Eurobond market or short-term rates in other currencies. Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF THE NATIONAL FOREIGN TRADE COUNCIL, INC.

I am Carter Gore, and I am testifying on behalf of the National Foreign Trade Council, a non-profit organization whose membership comprises a broad cross-section of over 600 U.S. companies with highly diversified interests engaged in all aspects of international trade and investment. I am pleased to comment on the issue of repealing the 30 percent withholding tax on interest paid to foreign investors on portfolio indebtedness imposed under Section 871 and 881 of the Internal Revenue Code.

The withholding tax on interest paid by U.S. borrowers to foreign investors is imposed at a 30 percent rate unless reduced by treaty. This tax makes investment in U.S. securities unattractive to foreign lenders. To obtain foreign funds, the U.S. borrower must agree to reimburse the tax, which makes the cost of borrowing from foreign sources prohibitive. While some tax treaties reduce the 30 percent rate, individual foreign investors must comply with burdensome refund procedures which frequently result in costly delays in obtaining a partial refund of the withholding tax.

Some foreign investment is currently being made in U.S. debt securities through finance subsidiaries of U.S. corporations incorporated in the Netherlands Antilles. We believe it is undesirable to foster a situation where such corporations are created and maintained to avoid the withholding tax. Repeal of the withholding tax would make such financing vehicles, which are generally available only to large investors and borrowers, unnecessary.

The Council believes that elimination of the withholding tax on interest paid to foreign portfolio investors would make the debt securities market in the United States more attractive to foreign investors. The additional investment in U.S. debt securities by foreign investors resulting in increased inflows, will improve our balance of payments position and thereby further strengthen the current position of the U.S. dollar. While we recognize that it is difficult to quantify the effects that removal of the withholding tax would have on the U.S. balance of payments, some estimates have been made by financial experts that the inflow could increase by \$5–7 billion annually if the tax is repealed. For 1979, it has been reported that the net private capital outflows total \$9.4 billion. Consequently, an inflow of \$5–7 billion would have offset the net private capital outflows in 1979 by about two-thirds.

The annual \$5–7 billion inflow was based on calculations made by two U.S. investment banking companies after discussions with their foreign branches. It assumes that approximately \$9 billion in Eurodollars will be available each year for bond investments, and approximately 50–80 percent of that could be shifted to the U.S. bond market. These computations do not take into account private placements which could substantially increase the inflow. But, of course, a number of other factors such as comparative yields, inflation rates, and funds available for investment could affect the magnitude of the inflow. The critical fact is that the U.S. needs additional capital for new investment in plant and equipment, which in turn will increase productivity and reduce inflation. Continuation of the withholding tax on interest is likely to keep enormous amounts of foreign private capital out of the U.S. bond markets.

The long-term revenue gains from taxes on profits, wages and dividends generated by the additional investment along with the reduction in foreign tax credits claimed for taxes paid to the Netherlands Antilles by financing subsidiaries should more than offset a revenue loss estimated to be in the magnitude of \$30–40 million annually.

Foreign holders of discount debt instruments with an original maturity of six months or less currently enjoy exemption from withholding. Extending the exemption to long-term instruments would contribute to a significant improvement of the liquidity of the United States' foreign investment position. U.S. external assets are predominantly direct investment, which is long-term in nature; by contrast, our external liabilities consist primarily of short-term debt. Any lengthening of maturities is, therefore, desirable since it would reduce the potential capital outflow when short-term interest rates decline relative to returns available in the Eurobond market or short-term rates in other currencies.

The official U.S. balance of payments programs, primarily the Interest Equalization Tax and the OFDI Restraints on Foreign Direct Investment, contributed to the substantial growth of the Eurodollar market after 1963. Restricted in its ability to finance expansion abroad by transfers of U.S. capital, American industry was compelled to raise funds in the Eurobond market. While suffering some disadvantages compared to the U.S. market, such as lesser size and depth, lack of efficiency, a poor distribution process, and inadequate disclosure requirements for borrowers, the Eurobond market offers the foreign investor two very important advantages, freedom from withholding tax and anonymity. The two advantages far outweigh the disadvantages of the Eurobond market.

Many foreign investors desire anonymity, particularly citizens of countries experiencing political instability, economic uncertainty (including risks of foreign exchange control), discriminatory taxation, and potential expropriation. After the U.S. Treasury's blocking of Iran's official accounts in U.S. institutions, protection of the investor's identity has taken on even more urgency. Since such anonymity is available in the Eurobond market, zero withholding tax will not make the U.S. bond market attractive if there is a U.S. requirement of disclosure of beneficial ownership of the bond interest flowing to the foreign investor. Were the U.S. debt security market to offer both freedom from withholding and anonymity, along with lower transaction costs, S.E.C. supervision and efficient aftermarkets, we believe U.S. debt securities would rapidly become more attractive to the foreign investor. We believe procedures can be developed to protect the anonymity of the foreign investor without creating an opportunity for U.S. investors to easily evade income taxes.

In closing, we urge that no distinction be made between old and new bonds in the repeal of the withholding tax. Inflows into the secondary market are as valuable to our balance of payments as inflows in new issues, and we believe that any difference in the treatment would create a two-tier market, with potential liquidity problems for old bonds, which is undesirable.

Mr. ROSTENKOWSKI. Mr. Hennessy.

STATEMENT OF JOHN M. HENNESSY, EXECUTIVE VICE PRESIDENT, THE FIRST BOSTON CORP.

Mr. HENNESSY. Thank you, Mr. Chairman. I am pleased to accept the invitation to testify today before this subcommittee of the Committee on Ways and Means in favor of elimination of the tax on interest received from portfolio debt investments in the United States by nonresident aliens and foreign corporations.

My views are drawn from my past service with the U.S. Government as an Assistant Secretary of the Treasury for International Affairs from 1972 to 1974 and from my current position in the private sector of the economy as the executive vice president of the First Boston Corp., an investment banking firm in New York.

My views, therefore, express my experience in both the public and the private sector of the United States and reflect an especial concern with international investment and capital flows.

At the outset I would like to emphasize that a prompt and general removal of this tax would be one of the quickest ways to promote increased portfolio investment in the United States. At a time in which the United States has experienced high rates of inflation and interest and low rates of investment, savings, and productivity, I can see no justifiable economic reason not to move promptly on this matter.

The matter has been debated for many years and the weight of objective analysis is overwhelmingly clear that the benefits to our economy far outweigh any potential costs.

In my statement today I will attempt to summarize briefly the major benefits as I see them and try to deal in a succinct way with the major arguments which have been made against removal.

The first and foremost reason for the repeal of the U.S. withholding tax is to enhance access to foreign sources of capital by the public and the private sectors of the United States. At the present time, the tax acts as a significant economic disincentive to foreign buyers of both U.S. Government and the private sector securities.

The tax works in two very concrete ways to restrict the flow of foreign capital to U.S. firms and the Government. First, the direct sales to foreigners of U.S. debt securities registered and issued in the United States is impeded. For example, if you are a nonresident foreigners and bought the recent American Telephone & Telegraph $600 million 10-year issue on the New York market, in most cases you would be subject to a 30-percent withholding tax.

Since, as a nonresident foreigner, you could also buy a dollar denominated Swedish, Japanese, or French telephone issue in the international offshore market without any interest withholdings, in most cases you would not buy the American Telephone & Telegraph issue. Estimates are that $5 to $7 billion of new direct funds would flow into the U.S. capital market if the tax is removed.

Second, the 30-percent U.S. withholding tax on interest payments makes it prohibitive for a borrower to bear the economic cost of the tax; conversely, because of attractive investment alternatives, it is impossible to place the economic burden of the tax on the purchaser. Accordingly, if a U.S. corporation wishes to be an issuer of debt outside the United States in the Euromarket, at the present time it could access the Eurobond market only through a finance subsidiary incorporated offshore.

It makes no sense to force U.S. corporations to organize subsidiaries in offshore centers—for example, the Netherlands Antilles—in order to borrow in foreign capital markets. No policy is served by requiring U.S. corporations to use relatively complicated and formal structures in order to accomplish indirectly a purpose that should be allowed directly.

This means, in effect, that if General Motors wishes to issue in the Eurodollar market, it must first set up a foreign subsidiary—generally in the Netherlands Antilles—before it can issue Eurobonds on a withholding tax-exempt basis. This is clearly an unwarranted restriction, one that Toyota, Datsun, and Renault do not have to contend with.

U.S. corporate issuers have now become only a small proportion of the users of the Euromarket, accounting for only 15 percent of the capital raised there in recent years, whereas they accounted for over 70 percent in the early 1970's. Other countries have more successfully accessed this market. One reason is the withholding tax.

If we look at the history of international capital flows, we see that it was essentially European capital which came to the United States in the 19th and early 20th centuries to build this country, mainly through portfolio investment.

This changed after World War II, when the United States had built up a significant surplus and supplied capital to the rest of the world, thereby becoming the banker to the world. In other words, we were not only the major source of long-term capital but the vast majority of international capital lending took place through U.S. institutions located here, with particular concentration in New York. This is no longer the case.

In the last 20 years, the Eurobond and banking market has grown to be an important source of world capital. Capital of $18 billion to $20 billion in new bond issues is raised annually.

As an aside, I should mention that the Euromarket has been a tremendous source of revenue and jobs for the city of London. All major commercial banks and investment banks in the world now have operations located there.

The British Government has been economically wise in keeping that international market place tax and regulation free. Measures such as elimination of withholding, which would increase New York's role as a financial center, would be a meaningful source of employment for the United States.

Thus the Eurobond market is an important potential source of capital for U.S. corporations for several reasons: At times, capital may be available at lower overall cost than in the U.S. market. It also offers other advantages, such as early optional redemption provisions not available for borrowings of comparable maturities in the U.S. market and debt covenants that are more flexible than those that would be required for comparable obligations in the U.S. market.

Although a majority of issues in the Eurobond market are denominated in dollars, the Eurobond market may also be a source of foreign currency for U.S. corporations.

While the benefits are clear, the elimination of the 30-percent U.S. withholding tax would not result in a direct loss of tax revenues of significance. As we have heard here today from Treasury, their estimates for 1979 were that taxes of only $33 million were collected. By simple arithmetic, that number, which is not a significant number in itself, means that total annual interest paid to foreigners would be in the order of $100 million, which leads you to the conclusion that if they are paying an average of 10 percent interest, as little as $1 billion of foreign investment is being taxed. The OPEC countries alone have $115 billion to invest this year.

So we are obviously attracting a very small proportion of those funds right now. Moreover, the tax collections are not meaningful. In fact, some independent tax experts believe that there may even be an increase in U.S. tax revenues because of the elimination of the foreign tax credit which now takes place in countries such as the Netherlands Antilles.

The net income of such foreign finance companies is subject to income taxes by those countries, and those taxes, in effect, are offset and passed on to the U.S. Government through the foreign tax credit system. The estimated amount paid to the Netherlands Antilles through the tax credit system is in the magnitude of $15 million.

There are some additional benefits which would accrue to the United States. An inflow of new capital into the United States from abroad will strengthen the dollar at a time when it is important that our domestic monetary policy not be unduly influenced by the need to keep interest rates high to maintain the dollar. We should be doing everything possible to make the United States an attractive place in which to invest, particularly through portfolio investment.

Finally, the present withholding tax has a bias against long-term investment in bonds since, currently, nonresident foreigners' deposits, certificates of deposits and purchase of commercial paper are permanently exempt from withholding on interest. These latter instruments are much more interest-sensitive and hence volatile, given their short-term nature.

As other speakers have mentioned, these short-term instruments are much more volatile and it is clearly in our interest to promote a stable investment in the United States—the longer, the better—and elimination of the withholding tax would contribute to that.

We have heard several arguments here today about the potential problems or difficulties that would arise. None of these seem to be economic. They seem to be of a general philosophical nature. Perhaps this is the time when the United States should worry less about theory, a little less about philosophy, and concentrate on economic facts, such as how to create more employment.

The major argument against elimination of withholding is that it would be unfair to American investors and make the United States a tax haven. I don't find the argument that U.S. investors in debt securities would be discriminated against as a convincing one for several reasons. First of all, at this point in time American investors in debt securities do not pay a withholding tax on interest.

Second, when American investors buy foreign securities themselves abroad in international markets, they do not pay withholding. So there would be a completely fair and symmetrical treatment of investors, U.S. or foreign, when buying debt securities outside their home country.

Finally, not to eliminate the tax and thereby not to promote more investment in the United States discriminates against investment and jobs here and against the growth of our own capital markets here in this country.

As regards the tax haven and tax evasion argument, I have to say that we have a very good example close by. In 1975, Canada removed its withholding tax and there is no indication whatsoever that it has become a so-called tax haven. I recognize that "tax haven" is sort of a buzz word but, the fact of the matter is that the elimination of the withholding tax, even in the worst case would not increase or decrease tax evasion. All international investment outside of the United States in international capital markets is already on the order of $100 billion a year, and that is not subject to withholding.

I don't think the people who oppose this bill can have it both ways. They state that, since there are tax treaties which now exist among major industrial countries, the elimination would not produce important capital flows. Well, then, they should not worry so much about it, about evasion or unfair gifts to foreigners.

I think the opposite is true, of course. There are important flows which are involved here. The new investing countries and the people within those countries who are now the savers within the world are not covered by tax treaties, and therefore it is extremely important that we move forward to eliminate the withholding and also try to negotiate tax treaties with those particular countries.

And, finally, on the use of withholding tax reduction as a bargaining tool, I think that is a wonderful, theoretical argument, but has no basis in fact because most countries think it is dumb to have a withholding tax. They are not about to make it any easier for their citizens to come and invest in the United States. So far as they are concerned we can keep the withholding on forever and they will be as pleased as Punch.

In sum, removal of the withholding tax would create significant incremental flows of long-term capital directly to our U.S. capital market, helping firms and the Government raise investment funds more cheaply and abundantly. This should create more jobs directly and in the financial and supporting sectors.

It will help the dollar and contribute to restoring the United States as an international capital center. It will remove the articificial and unfair situation of not having withholding taxes on short-term, more volatile funds and having it on longer term, more stable capital.

It will remove the necessity of setting up foreign financial vehicles so the Euromarkets can be accesed directly by U.S. borrowers.

It will result in no significant direct revenue loss and it will create additional overall tax revenue if more investment and jobs are promoted.

Mr. Chairman, we are in an increasingly competitive world, not only in trade but for scarce capital. It makes no sense to continue this tax, which generates small amounts of revenue and puts our capital market, our Government and our corporations at a competitive disadvantage. I hope you will move for its prompt elimination. Thank you.

Mr. ROSTENKOWSKI. Thank you, gentlemen.

Would anybody like to make a comment on someone else's statement?

Mr. REY. Mr. Chairman, if I may draw a parallel that may be of some help to the Congress here. The parallel has to do with taxation by States within the United States. Let us take New York and New Jersey as an example because they happen to be close to my home. New York taxes wages of people that live in New Jersey and work in New York City. They are subject to a wage tax in New York City and a State tax. However, New York does not tax a New Jersey resident if he buys a certificate of deposit of the First National City Bank or a bond of the city of New York.

The reason is simple. If New York were to tax a New Jersey resident on his investments in New York securities or securities of New York corporations, the man would not make the investment. He would go somewhere else. He would invest in Connecticut's bonds or in Maryland's bonds but not in New York bonds. That is exactly parallel to what the situation we in the United States face in the world today.

Thank you.

Mr. HUNTER. Mr. Chairman. I might add, the witness speaking against the legislation frequently used the phrase "tax evasion" and in the arguments against this legislation I imagine there will be frequent references to "tax evasion" and the charge that this is opening the way to tax evasion. Tax evasion is illegal. I am against it. I think everybody here is against it. But the issue is not tax evasion. The issue is tax avoidance and tax avoidance is a very common practice.

As a matter of fact I practice it. I think everybody practices it. Nobody pays more tax than he has to.

Now, let us take a bank in Germany. Take the Deutsche Bank and its representatives. I would not say they are guilty of tax evasion, but they certainly practice tax avoidance. Tax avoidance comes by reason of the fact that one doesn't purchase the affected securities. One avoids the tax by going in a different direction. I submit that this is hurting us in our efforts to sell our securities abroad. It adversely affects us in our efforts to make housing available in this country. It is not helping us in any way.

Mr. **Rostenkowski.** Mr. Hunter, would you then object to identifying the purchasers of the bonds?

Mr. **Hunter.** We don't object. We agree to targeting in foreign countries in Western Europe for example. We sell bearer bonds for the most part. I don't think we would object. I don't know that identifying the purchasers of our debt instruments serves any useful purpose. It only compounds the thing.

Mr. **Rostenkowski.** The question in issue in some respects here is the identity, is it not?

Mr. **Evans.** I don't think it is so much that we would object to identifying the investors. I think simply they would not buy the bonds.

Mr. **Rostenkowski.** Because they had to identify themselves?

Mr. **Evans.** Yes. Traditionally, the reluctance to identify one's assets in foreign countries predates income taxes. There are other reasons. There has been confiscation of private assets by governments in other countries. It just goes against the grain.

Mr. **Rostenkowski.** Well, it goes against the grain of some of us in Congress here too.

Mr. **Rey.** If I might add one point on that. The draft legislation we submitted requires, I think, exactly what the Congress would be concerned with, the identification of Americans. The United States' right to ask for the identification of foreigners is questionable, but we certainly have the right to seek identification of Americans to prevent tax evasion. The legislation that has been drafted can achieve that result without requiring Europeans to identify their assets and encouraging them, instead of buying an American bond, to buy a bond sold in the Eurobond market.

Mr. **Rostenkowski.** Mr. Hennessy, may I ask you a question? What do you estimate the percentage increase in employment and investment in this country would be if this legislation were passed? I take it you are trying to bring home the employment as well as the investment and I would like just a casual estimate of what you think the increase would be.

Mr. **Hennessy.** I would not care to hazard a guess. I think some research has been done. I would like to submit for the record some of this research. I think the nearest analogy you can make is to look and see what has happened to someplace like London which has benefited tremendously from the growth of the Eurobond market which has grown in the last 20 years. I think they have carried out a number of studies themselves that by having the international capital market move offshore to London, essentially replacing New York in that function, they have had a tremendous growth not only in bankers—about whom no one cares—but for auditors, lawyers, printers, paper suppliers, restaurants, hotels.

You can't get a hotel room in London any day of the week. That is aside from the benefits that would accrue here in the United States of more capital coming to General Motors or Ford. The auto industry in general will be able to access more funds more cheaply. That will directly impact. But I think most of these economic studies are very difficult to pin a number down on. It is fairly obvious that the order of magnitude of world investment that we see now, goes up to $100 billion a year—if we get a small incremental percentage of that flowing into the United States, there has to be a direct employment benefit for the firms that are borrowing and also in the financial service and support industries.

It just seems to me there is so much actual tangible evidence of what has happened in London, how really that country and that city were kept economically alive during the last 20 years when they did not have oil mainly by the financial sector. It was the only efficient rapidly expanding industry in that whole country and a whole series of communications and other industries grew up to help facilitate that.

I will try and develop for the record some of the studies that have been done on the importance just to New York City of the financial service industry and how it has grown and how greater growth would contribute to employment.

[The material follows:]

As I indicated in my formal comments, it is impossible to quantify with precision the direct impact on employment or other measures of economic well-being of the approval of the proposed legislation. Nonetheless, there is evidence which supports my general statement:

1. Studies performed by major investment banking firms have suggested that, were the proposed legislation enacted, in the area of $5 billion to $7 billion of new funds would flow into the United States annually. That being the case, and applying the capital/employment ratio of $24,000/1 which is widely used by economists, these funds could create approximately 250,000 new jobs nationwide.[1]

2. While not directly linked to the elimination of withholding, there are two examples which demonstrate how the general deregulation of capital markets can promote employment and taxable revenues. The financial services sector is a heavy employer and we should attempt to promote its growth, such as through the elimination of withholding taxes.

(a) While it may not be directly comparable to the present situation in New York City, the growth of London as an international financial center during the last two decades suggests the potentially dramatic effect of capital decontrol. As you know, London has become the single most important financial center outside the United States. Moreover, it has attained that position of preeminence as a direct result of a conscious policy by the U.K. Government and the Bank of England.

A few salient statistics illustrate the tremendous growth of that center. According to a recently published report on the City of London, the banking, discounting and other financial institutions of that city in 1979 employed a total of 448,000 persons, almost double the number (241,000) employed two decades earlier. Similarly, the number of foreign banks in London (either directly or indirectly represented) more than tripled over the past thirteen years, increasing from 113 in 1967 to 387 in 1979. Much more dramatic, however, is the increase in net overseas earnings of U.K. banking and other investment institutions, rising from £127 million in 1970 to £750 million in 1978, or to six times its 1970 amount in only eight years.[2]

(b) In conjunction with its analysis of the establishment of International Banking Facilities ("IBF's") in the United States, the New York Clearing House Association in July of 1978 concluded that the presence of such facilities in New York City would lead to the creation of between 5,000 and 6,000 new jobs in the city.[3] We estimate that this would result in an incremental annual payroll

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[1] Source: U.S. Department of Commerce, Bureau of Economic Analysis.

[2] Source. "The Report of the Committee to Review the Functioning of Financial Institutions," published in June 1980 by Her Majesty's Stationery Office, and the November 1979 edition of "The Banker" magazine, published by the Financial Times Business Publishing Limited.

[3] Source: "International Banking Facilities in the United States—An Analysis of the Economic Policy Issues," published by the New York Clearing House Association on July 14, 1978.

in excess of $100 million. For your background information, total New York City employment in the financial services sector as of April 1980 was 435,000 (slightly less than that of the same sector in London); of the total, 79,000 consists of securities and commodities brokers.[4]

Mr. GROOM. I would like to add a couple of points. As I testified we would support the bill that you have introduced. We do think there are some technical changes that are needed to deal with the peculiarities of life insurance company taxation. We invest in debt obligations through separate accounts that are treated as part of the life insurance company, and the payment out is regarded technically as an annuity payment rather than interest on a debt obligation. That may require changes.

But beyond that what we are asking for is an expansion of this proposal to cover, for example, common stock investments by foreign pension plans which are handled by U.S. financial institutions. In this situation the United States has the opportunity of getting additional capital invested in American corporations with no cost; we are not currently getting this investment because of the impediments of the withholding tax. Japanese pension funds can invest in Japan, for example, free of tax so that gives them a big incentive to invest in Japan rather than to invest in the United States.

So we think that the proposal that we are suggesting offers some additional advantages over your basic proposal, and really has none of the minus points that your basic proposal has and we earnestly hope it wil be incorporated.

Mr. ROSTENKOWSKI. Mr. Evans.

Mr. EVANS. It was suggested earlier this morning, not on this panel, that nothing has really changed since 1976 when this measure was last considered in the Senate, or 1975 when it was last considered in the House. The bill in the House that year also excluded dividends, so it was not exactly the same bill.

A number of things have changed since 1976. In the first place, foreigners now are permanently exempted from withholding tax on interest they receive on bank deposits and other short term investments.

Second, the lag in U.S. saving and investment rates and the extremely serious lag in our productivity are more widely recognized today than they were in 1976. The levels of interest rates these days are far less significant than the greater dangers of a deep recession, balance of payments deficits and the international position of the dollar.

Finally, the greater foreign desire to invest in the United States today is accompanied by a greater fear in our country that foreigners will gain too much control of companies and real assets. Such a threat is not posed by paper assets such as bonds. All of these factors represent changes since 1976.

Mr. ROSTENKOWSKI. Mr. Hennessy.

Mr. HENNESSY. I was going to address a similar issue to Mr. Evans and that was to ask you a question. Since 1921 foreign deposits, certificates of deposit, bank deposits, Treasury bills, have been exempt. That was made permanent in 1976 so clearly Congress must feel that has been in our best interest. They made it permanent after 55 years of extending it every two years. I think you have clear demonstrable proof that that has helped the U.S. attract capital in the banking system. Why doesn't it make sense to extend that into the longer term end of the market where we are now strapped for capital, particularly in the energy and housing industries? Why don't we try to induce them to do that for a longer term? Why doesn't it make sense on the longer term capital if it does on the short term?

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[4] Source. "Employment Review," published by the New York State Department of Labor.

Mr. ROSTENKOWSKI. Because you have not convinced the membership, Mr. Hennessy. That is what it is. You just have not convinced the membership.

Mr. HENNESSY. It is an inconsistency.

Mr. ROSTENKOWSKI. But it is an overwhelming inconsistency on the floor of the House of Representatives as was observed here. Any evasion of taxes or any unfair or imbalance of payment of taxes is very unpalatable to members on the floor of the House of Representatives. I think here in the Ways and Means Committee where we deal with these measures and have an indepth understanding of trying to develop sound economic policys for the country, I think you get a better understanding.

Mr. McIntyre, do you want to wrap it up?

Mr. MCINTYRE. Mr. Chairman, I think there is a fair amount of agreement among us on some of the issues. We all agree that with disclosure requirements this bill does not do anybody any good. So the issue comes down to whether we want to have the United States become a major participant in the international tax evasion—I use the word carefully—market. I don't think that is the right thing for this country to do. That is why we are opposed to the bill.

Mr. ROSTENKOWSKI. I understand that, too, Mr. McIntyre. You know we have been waiving our morals around the world and I am proud of that. But, at the same time, I just find it very unpalatable to continually tie the hands of the American businessman doing business in the world, putting business at a tremendous disadvantage.

This is an adventure for me. I don't like introducing legislation that is very unpopular with my colleagues, but I think that this is an opportunity for us to try and explore a very complex issue with many ramifications. On the one hand, we don't want our businesses operating at a disadvantage in international markets, yet we want to continue with other nations the understanding that we don't want tax havens and don't want them to have them either.

I recognize, after having been on this committee as long as I have, that we have to worry about productivity in this country. I think that is something in the 80's we are going to have to come to grips with and be very serious about.

I want to thank you for joining us this afternoon. It has been certainly an educational experience for me.

Thank you.

[See appendix for material submitted for the record.]

[Whereupon, at 1:25 p.m., the hearing was adjourned.]

MINOR TAX BILLS

THURSDAY, JUNE 26, 1980

House of Representatives,
Committee on Ways and Means,
Subcommittee on Select Revenue Measures,
Washington, D.C.

The subcommittee met at 10 a.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the subcommittee) presiding.

[Press releases announcing the hearing follow:]

[Press release of June 13, 1980]

HON. DAN ROSTENKOWSKI (D., ILL.), CHAIRMAN, SUBCOMMITTEE ON SELECT REVENUE MEASURES, COMMITTEE ON WAYS AND MEANS, ANNOUNCES A PUBLIC HEARINGS ON MINOR TAX BILLS TO BE HELD ON JUNE 26, 1980

The Honorable Dan Rostenkowski, (D., Ill.), Chairman, Subcommittee on Select Revenue Measures of the Committee on Ways and Means, today announced that the Subcommittee will conduct a public hearing on miscellaneous tax bills on Thursday, June 26, 1980. The hearing will be held in 1100 Longworth House Office Building, the Committee's main hearing room, beginning at 9:00 a.m.

A listing of the legislation on which testimony will be taken at this time appears on the reverse side of this announcement.

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD

The limited time available to the Subcommittee for this hearing requires that all persons and organizations having a common position designate one spokesman to represent them. Each witness must summarize his or her statement with the understanding that the detailed statement will be included in its entirety in the printed record of the hearing. The time allowed witnesses for the presentation of oral testimony will be strictly limited. If necessary, public witnesses will be grouped into panels to expedite the hearing process. Any individual or organization desiring to do so may file a written statement for inclusion in the printed record of the hearing instead of appearing in person, in accordance with the directions outlined below.

The cut-off date for requests to testify is the close of business on Monday, June 23, 1980. Requests to be heard, therefore, should be submitted by telephone to John M. Martin, Jr., Chief Counsel, Committee on Ways and Means, 1102 Longworth House Office Bldg., Washington, D.C. 20515, (202) 225-3625.

Requests to be Heard Must Contain the Following Information:

(1) The name, address, telephone number and capacity in which the witness will appear.

(2) A listing of clients (or the firm or association represented) at whose request or in whose employ the witness is appearing:

(3) Which bill or bills will be discussed; whether in support or opposition, and

(4) A summary of testimony to be presented.

Notification to those scheduled to appear will be made by telephone promptly after the filing deadline. If a witness cannot appear on the day scheduled, he may wish either to substitute another spokesman in his place or to file a written statement for the record of the hearing instead of appearing in person. In any event, if a change in the scheduled witness or cancellation is necessary, please advise the Committee office immediately.

Witnesses should submit 50 copies of their prepared statements to the Committee office, 1102 Longworth House Office Bldg., at least 24 hours in advance of the hearing. An additional supply may be furnished on the date of appearance for distribution to the press and public.

WRITTEN STATEMENT IN LIEU OF PERSONAL APPEARANCE

Instead of appearing in person, written testimony may be submitted for the consideration of the Subcommittee and inclusion in the printed record of the hearing. For this purpose, five copies of the statement should be submitted by the close of business on Thursday, July 3, 1980. If those filing for the record want copies of their statements distributed at the hearing to the members of the Subcommittee, press and public, additional copies for this purpose should be delivered to 1102 Longworth House Office Building before the hearing begins.

BILLS TO BE ADDRESSED AT PUBLIC HEARING, JUNE 26, 1980, BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES

H.R. 4498 (Mr. Weaver) To change certain requirements applicable to purchasers of timber from national forests, and for other purposes.

Similar to: H.R. 5798 (Mr. Gudger, Mr. Bafalis, Mr. Barnard, Mr. Bevill, Mr. Chappell, Mr. Preyer, Mr. Jones of North Carolina, and Mr. Andrews of North Carolina) To amend the Internal Revenue Code of 1954 to provide a tax credit for qualified forestry expenditures that improve the productivity of privately-owned lands, and for other purposes.

H.R. 5719 (Mr. Lederer) To amend the Internal Revenue Code of 1954 to clarify the tax exemption of proceeds from certain bingo games.

H.R. 6935 (Mr. Minish, Mr. Guarini, Mrs. Fenwick, Mr. Thompson, Mr. Courter, Mr. Hughes, Mr. Patten, Mr Rinaldo, Mr. Forsythe, Mr. Howard, Mr. Roe, Mr. Maguire, Mr. Florio, Mr. Hollenbeck, and Mr. Rodino) To exempt from Federal income tax certain subsistence allowances received by State police officers before January 1, 1978.

Similar to: H.R. 6953 (Mr. Hughes and Mr. Roe) To amend Public Law 95-427 to permit certain State police officers to file a claim for credit or refund of Federal income tax with respect to certain subsistence allowances, without regard to whether the allowance was included in gross income.

Identical with: H.R. 7149 (Mr. Roe)

H.R. 7263 (Mr. Conable, Mr. Gibbons, Mr. Duncan of Tennessee, Mr. Archer, Mr. Corman, Mr. Frenzel, Mr. Pickle, Mr. Jones of Oklahoma, Mr. Moore, Mr. Gradison, and Mr. Fowler) To amend the Internal Revenue Code of 1954 with respect to the treatment of retirement and similar plans maintained for nonresident aliens.

H.R. 7276 (Mr. Lederer) To amend the Internal Revenue Code of 1954 to allow the investment tax credit for certain rehabilitated buildings leased to tax-exempt organizations or to governmental units.

H.R. 7318 (Mr. Dingell and Mr. Jacobs) To amend section 170 of the Internal Revenue Code of 1954 to revise and make permanent the provisions for allowing a deduction for contributions for conservation purposes.

(Note: Supersedes H.R. 4611 (Mr. Dingell and Mr. Jacobs)—Hearings held by Subcommittee on November 9, 1979.)

H.R. 7392 (Mr. Gephardt) Relating to the treatment of certain expenses includible in the income of the recipient.

H.R. 7487 (Mr. Guarini, Mr. Rostenkowski, Mr. Florio, and Mr. Madigan) To amend the Internal Revenue Code of 1954 to impose a manufacturers excise tax on the sale of light gauge steel drums.

H.R. 7520 (Mr. Ullman, Mr. Gore, Mr. Pickle, Mr. Jones of Oklahoma, Mr. Jenkins, Mr. Lederer, Mr. Fowler, Mr. Duncan of Tennessee, Mr. Frenzel, Mr. Martin and Mr. Moore) To amend the Internal Revenue Code of 1954 with respect to the treatment of mutual or cooperative electric and telephone companies.

[Press release of June 18, 1980]

HON. DAN ROSTENKOWSKI (D., ILL.), CHAIRMAN, SUBCOMMITTEE ON SELECT REVENUE MEASURES, COMMITTEE ON WAYS AND MEANS, ANNOUNCES CHANGES IN THE PUBLIC HEARING ON MINOR TAX BILLS TO BE HELD ON JUNE 26, 1980

The Honorable Dan Rostenkowski (D., Ill.), Chairman, Subcommittee on Select Revenue Measures of the Committee on Ways and Means, today announced that the Subcommittee has scheduled an additional bill for its public hearing on Thusday, June 26: H.R. 7606 (Mr. Ullman) To amend the Internal Revenue Code of 1954 to amend the provisions relating to employee stock ownership plans, and for other purposes.

Mr. Rostenkowski also announced that the hearing will begin at 10 a.m., rather than at 9 o'clock, as originally scheduled. All other hearing details remain the same.

Mr. ROSTENKOWSKI. The subcommittee will come to order.

Today the Subcommittee on Select Revenue Measures is considering 10 measures which make various changes in the tax laws. While some of the bills to be considered here today would make relatively minor changes in the tax law, others would make somewhat broader changes and have aroused great interest. Among the latter is H.R. 7318 which would provide a permanent rule for the deduction of charitable contributions of certain partial interests in property. I would note that the subcommittee has already taken testimony on a similar bill, H.R. 4611, last year. This new version is the result of several months of work by the staff and interested groups. I am hopeful that any remaining differences can be reconciled in the near future.

I would remind the witnesses that the subcommittee is considering 10 separate bills today. Therefore I ask that witnesses summarize their statements as much as possible to facilitate the orderly yet efficient consideration of these bills.

We will begin today's hearing with the Members of Congress and then proceed to representatives of the Department of the Treasury and public witnesses. Adjustments in the published schedule of witnesses may be necessary, however, to accommodate other Members of Congress who have requested to be heard.

Mr. DUNCAN. The bills considered today focus on a broad range of important tax issues. For example, H.R. 7263 solves some major problems facing U.S. corporations that establish retirement plans for individuals most of whom are nonresident aliens. The bill is supported by Treasury.

H.R. 7520 clarifies the application of the section 501(c)(12) 85 percent income requirement in the case of mutual or cooperative electric and telephone companies.

H.R. 7487, on the other hand, deals with excise taxes, and imposes an excise tax of 20 percent on certain light steel gage drums. The bill thus raises revenues.

The other bills the subcommittee is considering today are also important. Mr. Chairman, your efforts in expediting consideration of these bills are to be commended.

STATEMENT OF HON. BARBER B. CONABLE, JR., A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Mr. CONABLE. Mr. Rostenkowski, Mr. Duncan, and subcommittee members, the hearing the subcommittee is holding today is of particular significance to me because it includes H.R. 7263.

Technically, H.R. 7263 is important because it establishes for the first time statutory rules governing the deductibility of retirement plan contributions that are made under plans that cover individuals, most of whom are nonresidents aliens. The rules will apply to U.S. businesses that conduct their foreign activities through branches or foreign subsidiaries.

In the case of foreign branch activities the bill assures a current tax deduction, while in the case of a foreign subsidiary the bill provides certainty in computing earnings and profits and in turn accuracy in foreign tax credit computations.

While these technical rules are important, perhaps the most important achievement of this bill is that it allows U.S. businesses to be more competitive in their efforts to employ qualified personnel. H.R. 7263 thus has a favorable trade impact. In many areas of the world today competition for qualified employees is very keen, and H.R. 7263 will assist U.S. businesses in attracting and retaining the most qualified employees available.

I thank you for this opportunity to testify, and hope the subcommittee will act favorably on H.R. 7263.

Mr. ROSTENKOWSKI. I call first my colleague, an outstanding member of the Ways and Means Committee, a hard-working Missourian. Mr. Gephardt, proceed with your testimony.

STATEMENT OF HON. RICHARD A. GEPHARDT, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MISSOURI

Mr. GEPHARDT. Thank you very much, Mr. Chairman, and thank you for the opportunity to bring the bill before the committee. I am sure that the chairman is well aware of the measures that are involved in this piece of legislation.

To quickly summarize the merits that we are dealing with here, the purpose of this bill is to clarify the continued viability of a rule originally set forth in section 1.274–2(c)(5) of the Treasury regulations. In short, the rule in question provides that a taxpayer who compensates another person with a travel award rather than cash is entitled to a tax deduction for this compensation if—and only if—it is includible in the taxable income of the recipient.

This problem originally arose as a result of the amendment affecting foreign conventions added to the code by the 1976 Tax Reform Act. In order to clarify the intention that these amendments should apply to the traveler, and not to the payor, under circumstances where a travel award is includible in the income of the traveler, section 274(h)(6)(D)(ii) was included in the 1977 Technical Corrections Act and added to the code as part of the Revenue Act of 1978. Unfortunately, a question then arose as to whether this legislative change might be overridden by the new rules regarding entertainment facilities also included in the 1978 act. As a result, a clarifying amendment, applicable only to the years 1979 and 1980, was enacted as part of the Technical Corrections Act of 1979.

The solution adopted in the 1979 Technical Corrections Act was made temporary rather than permanent as a result of questions raised by the Department of the Treasury concerning the drafting of the amendment. This problem has now been resolved and I understand the Treasury supports H.R. 7392 as a permanent solution to the problem. In order to meet Treasury's objections, the solution adopted in H.R. 7392 will not apply in any case where a travel award is required to be included on an information return and is not so included. For this purpose, an information return would be required even for awards which are less than $600. We tried to clarify this point in the regulations and changes affecting foreign conventions, but to date we have not been able to do that. As the chairman well knows, we also attempted to do this in the Technical Corrections Act of 1979, but for a lot of good reasons it was not possible to do that. Accordingly, I have introduced this legislation.

The bill does two straightforward things. It provides for the disallowance of expenses for entertainment, amusement or recreation and it also points out that this exception would not apply to a payor unless he furnishes the IRS with an Information Return Form 1099 indicating the amount to be included in the gross income of the payee. This is important regardless of the amount involved. As you know, in most cases that kind of reporting is only required when the compensation is above $600. In this area, we would say that it has to be given even when the compensation, the prize or the incentive of a reward is $1 or $5. Any amount, it would have to have that kind of treatment.

I have a letter dated May 29, 1980, from Donald Lubick, the Assistant Secretary of the Treasury (tax policy) in which he indicates that Treasury has no problems with this bill. We have talked to them a good deal over the past few months about it and I feel that they now feel it is an acceptable piece of legislation.

I would close by simply requesting that, if possible, this legislation be brought into markup and moved out of the committee and out of the House because, as you know, we have an interim solution that applies to this industry that will expire at the end of 1980. This industry sells contracts across the country and will be selling these contracts at the end of the year for 1981 and if the Congress has not acted and the interim solution expires at the end of 1980, they will be crippled in their ability to sell them.

I thank the committee and the chairman very much for their consideration.

[The prepared statement follows:]

STATEMENT OF HON. RICHARD A. GEPHARDT, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MISSOURI

Mr. Chairman and members of the committee, I appear here this morning to support the prompt enactment of H.R. 7392, which would eliminate a possible ambiguity concerning the tax treatment of incentive travel awards. This amendment is supported by Maritz, Inc., an outstanding St. Louis based company, as well as other companies engaged in the business of conducting and designing incentive programs which offer travel awards to persons who attain high levels of achievement and productivity.

The purpose of the bill is to clarify the continued viability of a rule originally set forth in section 1.274–2(c)(5) of the Treasury regulations. In short, the rule in question provides that a taxpayer who compensates another person with a travel award rather than cash is entitled to a tax deduction for this compensation if it is includible in the taxable income of the recipient.

This problem originally arose as a result of the amendment affecting foreign conventions added to the Code by the 1976 Tax Reform Act. In order to clarify the intention that these amendments should apply to the traveler, and not to the payor, under circumstances where a travel award is includible in the income of the traveler, section 274(h)(6)(D)(ii) was included in the 1977 Technical Correction Act and added to the Code as part of the Revenue Act of 1978. Unfortunately, a question then arose as to whether this legislative change might be overridden by the new rules regarding entertainment facilities also included in the 1978 Act. As a result, a clarifying amendment, applicable only to the years 1979 and 1980, was enacted as part of the Technical Corrections Act of 1979.

The solution adopted in the 1979 Technical Corrections Act was made temporary rather than permanent as a result of questions raised by Treasury concerning the drafting of the amendment. This problem has now been resolved and I understand the Treasury supports H.R. 7392 as a permanent solution to the problem. In order to meet Treasury objections, the solution adopted in H.R. 7392 will not apply in any case where a travel award is required to be included on an information return and is not so included. For this purpose, an information return would be required even for awards which are less than $600.

I urge the committee to mark-up and approve H.R. 7392 so as to finally resolve the issue described above and eliminate any question which might otherwise adversely affect the deductibility of incentive travel awards which constitute taxable income to the recipient.

In closing, Mr. Chairman, I note that you have recently introduced legislation to further revise the foreign convention rules. You and your Subcommittee are to be commended for this forthright effort and for your efforts to resolve this matter that I have proposed. Thank you.

Mr. Rostenkowski. I thank you, Mr. Gephardt, for shedding light on this legislation. I know we have discussed this on many occasions and I am sure that we will try to expedite the markup on this as soon as possible.

Are there any questions of the witness?

Mr. Duncan. I have no questions. I thank our able colleague.

Mr. Rostenkowski. Thank you very much.

Welcome, Congressman Weaver. It is a pleasure to have you here. If you will proceed with your testimony.

STATEMENT OF HON. JAMES WEAVER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OREGON

Mr. Weaver. Yes, Mr. Chairman, I have a full statement.

Mr. Rostenkowski. Your entire statement will be included in the record.

Mr. Weaver. I will summarize very briefly, Mr. Chairman.

I am here to speak for an investment tax credit on reforestation. The need for trees is growing in this Nation. It is an urgent need. We have a timber shortgage. The Forest Service figures show that the number of trees being grown today on both private and public land will not meet our needs. We import timber now from Canadians and they too will have shortfalls and will reduce their international sales. So in the next 20 to 30 years the people and homebuilders of Illinois and Tennessee and other States of the Nation, are going to face severe shortages. We must grow trees.

Now the main place we can grow more trees is on small woodlots. Private forest lands produce only one-third of our timber supply yet represent 58 percent of the forest land base. It is very simple why these owners don't plant trees. A tree does not grow to maturity for 50 to 120 years. Owners do not realize the fruits of their forestry investments in their lifetimes.

Our present tax laws are disincentives to reforestation, just the opposite of what they should be. Most sums spent on reforestation today go into dead capital accounts, they are not even expensed. There is no incentive in our tax laws to grow trees. Capital gains tax treatment is an incentive to cut the tree but not to grow the tree. Now a tree is a commodity. It takes 30 to 120 years to grow a tree. This growing period is one of high risk from insects, infestation, fire, and disease. So I urge, Mr. Chairman, that the committee make our tax laws responsive to the growing needs of our Nation for timber. I have proposed to the Forest Subcommittee, as chairman of that subcommittee, after many hearings, a bill, H.R. 4498. It provides for an investment tax credit for reforestation expenditures for landowners owning lands suitable for timber production. This bill recognizes the need to encourage small, private nonindustrial landowners to invest in their land.

I have proposed a tax credit of 25 percent of qualified forestry expenditures up to $50,000 on the small woodlot plus 10 percent of the qualified forestry expenditures in excess of $50,000. The benefit is reduced for the larger industrial landowners. I have always found it to be incomprehensive that one gets an investment tax credit for the construction of a warehouse but not for the planting of a tree. The warehouse produces revenue immediately upon construction but a tree may not return income for 50 or 100 years. Nothing could be better qualified for investment credits than reforestation and nothing, Mr. Chairman, is more urgently needed.

That concludes my statement, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF JIM WEAVER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OREGON

Mr. Chairman, distinguished Members of the committee, it is indeed a pleasure to have this opportunity to appear before you. I would like to testify today about one of the least recognized and most pressing problems in the Nation, namely, the lack of reforestation on private forest lands.

Timber is a renewable resource. It can be regrown. A forest, in its natural state, is in a constant cycle of destruction and renewal. Harvesting of mature trees replaces their natural demise through fire, insect infestation and disease. But regardless of how a forest is brought to the renewable stage—whether by harvesting or by natural means—the natural process of regeneration is too slow, too haphazard in most cases. We can aid the natural process by preparing the soil, planting, thinning, and protecting the young trees as they grow to maturity. Such forest management practices can double the volume of usable wood produced on a given acreage.

But why doesn't every forest landowner adopt these practices? Mr. Chairman, Members of the Subcommittee, the answer is four-fold:

1. The costs of reforestation are large: from $70 to $300 per acre in the Pacific Northwest, and from $30 to $200 in the South;
2. The return from investing in information in reforestation and timber growing accrues only after many years have elapsed; 30 to 35 years in the South and 45 to 60 years in the Far West;
3. The uncertainty associated with timber growing is great because of fire, insects and diseases; and
4. The rate of return for reforestation and timber growing have been low to date: about four percent in western Oregon and Washington and about eight percent in the South.

It is my view that market forces are not effectively allocating resources for investment in reforestation. The signals of the market are too often "to cut it and forget it." It is biased toward present consumption of, to disinvest in, our timber resources. The U.S. is a net importer of timber producers. If not checked, the result will be a poor and inadequate legacy for future generations.

It might have been argued a few years ago, that timber resources are not critical since substitute products are readily available, substitute products made from plastics, aluminum, steel, and concrete. But the world has changed! The relative price of energy has risen sharply. And those substitute products are no longer so readily available. The energy requirements for their production are too great.

It also might have been argued a few years ago that we can turn elsewhere in the world for our timber supply. But less developed countries have been expanding their capacity to make wood fiber products at a much slower rate than was anticipated. Canada will not be able to supply our need for wood products in just 20 years. Further, informed observers have found tropical deforestation and loss of agricultural land for both fiber and food crops is substantial and increasing.

Our present tax laws are disincentives to reforestation. Most sums spent on reforestation go into dead capital accounts—not even expensible—this on a commodity that takes 30 to 120 years to grow at high risk. Therefore, we are falling way behind on reforestation on the very lands we count most on for wood in the future. The small woodlot owner with millions and millions of acres of the best timber growing land in the country.

I say this after reading scores of studies, after listening to the testimony of over 250 witnesses during the past three years as Chairman of the Subcommittee on Forests.

I am suggesting that we urgently make our tax laws responsive to the growing needs of our nation for timber. I have proposed and the Forests Subcommittee has approved H.R. 4498, a bill designed to attract investments in reforestation.

It provides for an investment tax credit for reforestation expenditures for landowners owning land suitable for timber growing.

The investment tax credit has two levels in recognition of the need to encourage small, private, non-industrial landowners to invest in their land. I have proposed a tax credit of twenty-five percent of qualified forestry expenditures up to $50,000, plus ten percent of the qualified forestry expenditures in excess of $50,000.

I should mention one other important feature of the legislative proposal. The bill also applies to the establishment of shelterbelts. They protect farm lands from wind and water erosion. They promote moisture accumulation in the soil, and provide vital habitat for wildlife.

In recent years there has been a systematic and substantial loss of shelterbelts in the Great Plains due to a fence-to-fence farming policy and the succumbing of shelterbelt trees planted during the nineteen thirties to the ravages of weather, time, insects, and diseases. Tremendous public benefit accrued to the shelterbelt planting effort of the thirties, and that effort should be renewed. I suggest a tax incentives is an effective means to bring it about.

Mr. Chairman, members of the committee, the proposal I have before you is the product of synthesis of testimony before the Subcommittee on Forests as well as innumerable discussions over the past three years. It is the product of a nation-wide solicitation of views of forest landowners and industry representatives on several financial incentive proposals for forests landowners.

The Forests Subcommittee is not interested in taking jurisdiction from the Ways and Means Committee on a tax bill—in no way. The Ways and Means Committee has the significant and major jurisdiction over H.R. 4498. The Forests Subcommittee approved this bill simply as a sign to the Ways and Means Committee that we have held the hearings, are knowledgeable on this need, see its urgency, but we want the Ways and Means Committee to determine if it is within the national financial interest to allow a tax credit.

The Forests Subcommittee, however, sees an urgent need for reforestation and improved management of our private forestland and has heard testimony at hearing after hearing that it is the tax provisions in today's law which inhibit this reforestation and timber management. I strongly urge you to approve this bill.

I have always found it to be incomprehensible that one gets an investment tax credit for the construction of a warehouse but not for the planting of a tree. The warehouse begins returning income immediately upon its being rented; a tree may not return income for 50 or 100 years. Nothing could better qualify for an investment tax credit than reforestation.

Therefore, I would hope this subcommittee would pass this bill out and that the Committee on Ways and Means would follow suit.

Thank you very much for the opportunity to share my concerns.

Mr. **Rostenkowski.** I understand your situation, Mr. Weaver, but you know there is an argument made that the Federal Government already is providing numerous incentives or subsidies in the forest industry. I find it hard to believe that there are real disincentives that you talk about.

Mr. **Weaver.** Yes, Mr. Chairman. There are no expenses which can be deducted. If you spend $50,000 to reforest your area you get no return on it for 50 or 100 years, none at all, and you cannot expense any of it. It just sits in a dead capital account for that time and no income is being returned as in a warehouse or a piece of equipment. As a matter of fact, a tree must be cared for down the way, so there are additional management costs. There is just simply no incentive for the private landowners to grow trees and so therefore we are not growing them.

Mr. **Rostenkowski.** Mr. Duncan.

Mr. **Duncan.** Growing trees, you do get capital gains?

Mr. **Weaver.** Right, as an incentive to cut the tree but not to replant it.

Mr. **Duncan.** I understand your problem. I do want to thank you.

Mr. **Weaver.** I appreciate that very much.

Mr. **Rostenkowski.** Mr. Gudger, welcome to the committee. We certainly look forward to your testimony if you would like to proceed with your testimony.

STATEMENT OF HON. LAMAR GUDGER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NORTH CAROLINA

Mr. **Gudger.** I will try to be quite brief and confine the prepared statement and request that it be made a part of the record.

I follow a man who has already introduced from his experience on the west coast the needs for some incentive for forestry reinvestment and that is exactly what this bill, H.R. 5798, also addresses. The two approaches are somewhat different in machinery and in objective but they are quite similar in trying to address the same problem. I approach the problem, of course, with my concerns from the Southeast. I might mention to the committee that while the demands over the next 50 years are anticipated to increase for soft woods by 57 percent, hard woods by 160 percent, the incentive to the woodlot owner, the small woodlot owner, as referred to by Mr. Weaver in his testimony and recapitulated by me here, the incentive by the farmer is to cut that out and put it in some form of agricultural production which will yield an annual income and not be tied up for 30, 40, or 50 years over a long growth period.

Now 60 percent of commercial forest lands, nearly 75 percent in the South are owned by private, nonindustrial landowners and in North Carolina that ratio is 80 percent. However, only 36 percent of annual removal of growing stocks comes from these small woodlot owners. Now the purpose of this bill, which is different in graduation and different in some of its machinery from that used by Mr. Weaver, is to induce and to reward the small private land owner who has 10 or more acres of land, give him an opportunity when he reforests, when he plants, when he does anything to upgrade the recreational and forest production values of his land to make an immediate recapture. The recapture is graded according to the amount of the annual investment.

There is a provision in here for partnership or other investments so that there will be no double capture and particularly there is a provision in here to where if any costs are expended as a result of funds provided under other forestry program acts that these will not, of course, be tax credits or recovery.

So we think sincerely that this problem must be addressed. We will be happy to give a detailed analysis of the features of the bill which we are offering beyond stating its purpose and its intents but to continue in my State of North Carolina to own and retain in private ownership 80 percent of our forest in that area and to see that they are replanted and not destroyed and put to pasture or put to other agrarian use.

Now if there are any questions about my approach as distinguished from Congressman Weaver's approach, I will be happy to answer those questions but the differences are not great, the purposes are the same.

[The prepared statement follows:]

STATEMENT OF HON. LAMAR GUDGER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NORTH CAROLINA

Mr. Chairman and my distinguished colleagues of the subcommittee, it is now time for our country to anticipate the future demands that are going to be made upon our limited resources. For this reason, I have introduced and several of our colleagues have sponsored the "Forestry Incentive Act of 1979" (H.R. 5798).

My bill is an attempt to address the serious problem facing us in regard to the future supply of wood and wood products, which are destined to play an important role in our nation's future. A recent Forest Service Resources Planning Assessment indicated the demand for softwood sawtimber will increase 57 percent by the year 2030, and the demand for hardwood sawtimber will increase by 160 percent over the same period.

While the demand levels for wood products are projected to increase dramatically over the next 50 years, the outlook is bleak on increases on the supply side. This outlook is a result of: the continued withdrawal of federal land from timber production; the inability of industry lands to significantly increase production; and the lack of investment in forestry by the small non-industrial landowner.

I believe the solution to the supply problem of wood products lies in the hands of the private non-industrial landowner, who owns 60 percent of the commercial forest land nationwide and nearly 75 percent of the commercial forest land in the South. In my own state of North Carolina, the private nonindustrial landowner accounts for 80 percent of the commercial forest land. However, nationwide, these lands record only 36 percent of the annual removal of growing stock.

Current data indicates that few of the estimated million small forest landowners in the South, and other regions of the country, are practicing forestry on their lands. The Forest Service estimates that timber stand improvement work is needed on 90 million acres in the South alone. On the other hand, many of these lands are being harvested and not being replanted. This could be devastating to us in the future!

The small landowner lacks the appropriate incentives to properly manage his land for multiple-use purposes. Reforestation costs and the current tax structure actually discourage investment in forestry. The outlay on reforestation can reach up to $150 per acre without any income being generated for 20 or 30 years. Current tax regulations compound the problem by only allowing these costs to be deducted from income earned at the time the trees are harvested or seed planted. The fact is that many landowners cannot afford to carry reforestation costs for 20 or 30 years without some incentive to do so. The manufacturing factory owner is provided tax credits to make capital investments, and I believe it is time for the forest landowner to receive the same incentive to invest in his factory—the land!

H.R. 5798, if enacted, would provide the private nonindustrial landowner the necessary stimulation to engage in reforestation and forest management prac-

tices. I know you will give this important matter your careful attention, and I hope you will give it favorable consideration.

Mr. ROSTENKOWSKI. Thank you. Actually you are helping shed light on a very difficult situation to a person whose district has very few trees.

Mr. GUDGER. I am aware, Mr. Chairman, and I think it has been fortunate that Mr. Weaver from the west coast and I from the Southeast have addressed this problem out of the concern that we in North Carolina do have a great deal of forest land but it is being cut back and apparently the same is true in the big timber in the West.

Mr. ROSTENKOWSKI. We certainly appreciate the fact that you are shedding some light on this and helping us in our decisions.

Mr. Duncan.

Mr. DUNCAN. Thank you, Mr. Chairman.

I might say I went to the Chairman's home town and I remember seeing three or four trees. [Laughter.]

I do want to welcome my neighbor from North Carolina. My district adjoins Congressman Gudger's and I don't suppose anyone knows more about the problems of the tree growers in the forestry industry than you do and we deeply appreciate you being here.

Is your interest mainly in the small timber growers?

Mr. GUDGER. Indeed it is, Congressman Duncan, and I am so grateful you are here. You and I share responsibility for the Great Smoky National Park but as you and I both know so much of this acreage that is not federally owned is owned by the farmer who is having to increase his yields and increase his annual income. Now he does not see an immediate increase after he has cut that timber and the incentive is to put it to pasture and raise beef or to plow it under and plant a crop. You have the same situation in your district that I have in mine. It would be our small farmers who will benefit from this act, not the big corporate owners.

Mr. ROSTENKOWSKI. Thank you very much.

Mr. GUDGER. Thank you, Mr. Chairman.

Mr. ROSTENKOWSKI. Mr. Halperin, welcome.

I would like to point out to the public witnesses that it is the intention of the Chair to work through lunch. There will be possible interruptions because of rollcalls taken on the floor of the House of Representatives but we intend, as has been our custom, to work right through lunch.

STATEMENT OF DANIEL I. HALPERIN, DEPUTY ASSISTANT SECRETARY (TAX LEGISLATION), DEPARTMENT OF THE TREASURY

Mr. HALPERIN. Thank you, Mr. Chairman.

The Treasury's views on these 10 bills are set out in the summary beginning on page 32 of our prepared statement. As you indicated in your opening statement, there are a number of very important and difficult issues here and I can only touch on a few of the points that are discussed in this large volume that we have presented to you this morning.

The Treasury opposes in full only three of the bills that are before you this morning. We have objected to H.R. 7276 which is bill number five described in the pamphlet before you. We have also objected to H.R. 5619, not as a matter of principle. There the question is the taxability of bingo games and the question as to whether they are legal or not under State law. We think it imposes an unreasonable burden on the IRS to have to determine in particular cases whether the State law is being enforced or not. The IRS is entitled to have standards to operate by.

We have also objected to H.R. 4498 and H.R. 5798, the bills dealing with the timber industry which you have heard previous testimony on this morning.

You will note most of our rather extensive statement on that bill deals with the question of what appropriate expenditure policy would be. This is essentially not a tax issue but the real question is whether or not we ought to be spending more money in terms of a Federal subsidy to the timber industry. We have had difficulty in the past with the use of the tax approach as opposed to the expenditure approach. For one thing, there are few budgetary controls. In this time of tight budget and efforts to balance the budget, cutting down on lots of programs, nobody talks about cutting back the subsidy to the timber industry.

Second, when you use the tax system you tend to be inefficient in that you give greater benefits to high bracket taxpayers than those in the low brackets. We point out in the testimony that the subsidy for timber is in effect a 43 percent subsidy or payment for each dollar expended to corporate taxpayers in the 46 percent bracket, 35 percent to individuals in the 35 percent bracket and, of course, would be higher than the 43 percent to individuals in the 70 percent bracket. So there are problems with tax expenditures generally. We note in particular in this case that the present subsidies to the timber industry result in a negative tax. If the income tax system were repealed tomorrow, the timber industry would be worse off rather than better off.

With respect to H.R. 7606, which is the last bill on the list before you, we do not object to all but one provision of the bill dealing with voting rights. The present law provides that in the case where a defined contribution plan, a plan which the employer makes specific contributions which are allocated to the employees' account, invests in employer stock that voting rights on certain important corporate issues be passed through to the members of the plan, the employees who are participating in the plan.

We have indicated on a number of occasions there is a conflict with the efforts of ERISA to provide a secure pension benefit when you allow pension plans or profit sharing plans to invest in employer securities. The employee interest are not protected by the funds of the plan, the employee in effect comes after all the creditors of the employer because all he has is a stock interest. The efforts to have funding to protect the pension are therefore interfered with and therefore there must be a strong policy reason to depart from the normal ERISA rule. It is argued that the employees would have an ownership interest in the business and a greater motivation to work harder, et cetera. We believe if that is the case the employee has to know and be told what is going on. They are entitled to the information that owners would get and they are entitled to have the right to vote that owners would have. Therefore, we feel quite strongly that the present provisions ought to be retained. Aside from that we do not object to H.R. 7606.

We also support H.R. 7392, No. 7 on your list, which Mr. Gephardt testified in favor of this morning. We indicate in our testimony, however, that we would prefer a broader approach to the information reporting issue. We would like to get copies of the information returns to be required to be sent to the recipients as well as the Internal Revenue Service and we also would like to see greater penalties for noncompliance. Under present law the penalties are so small there is widespread ignoring of the requirements.

We also support H.R. 7263 which is No. 4 in the pamphlet. That is a rather complex issue dealing in effect with the question of the deductibility of pension costs, by foreign entities which are related to U.S. corporations, either branches of subsidiaries of U.S. corporations who establish pension plans overseas for essentially nonresident alien employees. The question really is whether the rules which are applicable to deductions by domestic corporations operating in the United States should apply to overseas operations. We think that a change in the law would be appropriate. To take a rather, perhaps, extreme example, if a pension plan established overseas met all the conditions of the Internal Revenue Code, but required vesting after 11 years rather than after 10 years, a possible reading of the present law is to deny deductions for contributions to that plan in most circumstances. Therefore we think a change in the law is appropriate. There may be some differences of opinion as to how far to go or how to deal with the rather complex issue but we think there is a general agreement on the approach to be taken and we are satisfied that a proper result can be worked out.

We discussed in our testimony the question as to the treatment of subsidiaries as opposed to branches. Our statement in the summary says we do not support the provisions regarding computations of earnings and profits. I think a more precise way of saying that would be that we think that change is unnecessary because it would follow from the change for the branches.

However, we have also indicated in our testimony that we can see reasons why one would be willing to accept retroactive treatment in the case of foreign subsidiaries because we think it is a possible interpretation of present law that there is a difference from the treatment of branches; that is, the precise rules of computing earnings and profits should not apply to subsidiaries. Therefore, we could see the treatment of subsidiaries being retroactive. We do not support however a general retroactive approach to H.R. 7263.

We have also indicated our general support for item number 9, H.R. 7520. That deals with the cooperative telephone and electric companies and the question is whether they are subject to the unrelated business tax when they rent their poles to other utilities for the purpose of stringing wires. We do not object to that portion of the bill. The bill goes on, however, to deal with the question of whether these organizations shall qualify for the exemption. Under present rules in order for the organization to qualify for tax exemption, they must receive 85 percent of their income from members.

The purpose of that rule is to prevent—well, to explain it by a example. If a cooperative telephone company had a large investmen portfolio which was invested in the stock market and earned dividend and interest that were required tax free, people would basically b able to pay for their telephone service with pre-tax dollars. Nobody would pay tax on the income. On the other hand, of course, most people have to pay their income taxes before they have money left ove to pay their telephone bill. Present law restricts the advantage by limiting the outside income to 15 percent.

Under the proposal before you certain types of income from advertising in the yellow pages and from carrying wires of other co-ops would not be counted toward the 15-percent limitation on the outside income. We would be concerned about that rule particularly if the income would tend to come from nonmembers. If the case that people have in mind is a situation where an electric company and a telephone company served the same group of people, then the 15-percent rule is not being compromised. However, if they are earning that income from those who are not members of a co-op, there are serious problems that need to be considered.

We have also indicated general support or lack of objection to No. 3, H.R. 6935, dealing with the meal allowances for police officers. When the bill which is being amended here first went into effect i 1978 we indicated serious problems with it. What the bill did, as you probably recall, certain police officers claim that their meal allowances were not subject to income tax despite some fairly clear indications to the contrary and certainly the consistent Internal Revenue position, though the courts were somewhat in dispute in the area. When the Supreme Court held that the income was taxable, Congress considered an amendment to make that Supreme Court decision perspective only. But what it did was to give relief for prior years only to those people who ignored the IRS interpretation and excluded the meal allowances from tax. Those who follow the IRS interpretation were not given the relief.

As we have pointed out, and let me read the testimony we gave at the time we objected to the bill, "We felt we cannot administer the tax system if taxpayers who unsuccessfully contest an IRS position are liable for taxes only for years following the Court decision." This is unfair to those who do not contest the position and encourages everyone to take aggressive positions on their returns since they have nothing to lose and everything to gain by doing so.

H.R. 6935 recognizes the unfairness of the prior legislation and now opens it up to those people who did report the meal allowances as taxable income but now would like to have the exclusion the same as those who did not.

We cannot object to that since we think that that is a matter of equity but there is a further point in the bill and the question is the statute of limitations. Are people going to be able to seek refunds for 1969. We feel quite strongly about opening up the statute of limitation. Of course the statute of limitation in a sense is always unfair because it denies relief to somebody who on the merits is entitled to it but there is an important administrative concern in not opening up old years as to which records are stale, to which the IRS might not have copies of returns on hand and to which the possibility of fraud is certainly substantially increased. Therefore, we generally remain opposed to any weakening of the statute of limitation.

We recognize in this case it would mean very little to pass the bill and not change the statute of limitation because those people who would have been in a position 2 years ago to file refunds would have had the statute run on them in the meantime. Therefore, we think it is a reasonable compromise to go back to the way it existed in 1978 when the bill was first passed and allow those who would have been able to file refund claims to file them at this point. When they were barred then, they should be barred now. After all, the 1978 act did not open the statute and there is no reason to do so today.

Let me turn briefly to item number H.R. 7487 which imposes an excise tax on light gage steel drums. The purpose of this bill is to encourage people to use heavy gage steel because it is believed that those are reconditioned and used a number of times and therefore there would be less of a problem of litter from the discarding of the old used drums.

We recognize that there is a problem of litter and pollution caused by the disposal of containers, particularly those that may be contaminated. It is particularly true if the user, the one who has used the drum and is now disposing of it, does not bear the cost of disposing of used drums. An excise tax equal to the cost that the society bears from the disposal of the used container is a way of internalizing the cost and imposing it on those people who are using the product. We really don't know though to what extent H.R. 7487 will reduce pollution or to the extent that it may impose excessive costs on the business community. So therefore we feel that there needs to be further study of this problem. There may be other solutions to deal with it rather than the one that has been suggested today.

That leaves us with No. 6, H.R. 7318, which I think in many ways is the most far-reaching and important bill before you. As the chairman indicated in his opening statement, there was a prior hearing on this subject, H.R. 4611, and since that time we have spent a lot of time in consultation with interested groups in an attempt to develop a mutually satisfactory solution to this problem. We hope that there has been greater understanding on both sides of concerns that each of us have in dealing with this issue.

There are, however, a number of additional issues. I think the joint committee pamphlet does a good job of setting them out and we think that H.R. 7318 is not a fully satisfactory solution. We cannot support it in its present form. However, we remain hopeful, as the chairman stated, that the parties here can continue to work toward a solution that is satisfactory to all of us.

Let me say first we recognize the value of easements for conservation purposes. We recognize that it often may be difficult to have a direct purchase of land, that the owner may be unwilling to part with it or that it may be difficult for the agencies interested in conservation to come up with the funds to purchase the fee interest. Therefore, it is certainly a reasonable and useful alternative to have a conservation easement as an alternative to an outright acquisition.

However, when the Government expenditure or the public expenditure toward obtaining the conservation easement does not come from direct acquisition but rather comes through the tax system, the issues are more difficult. If the Department of Interior uses appropriated funds, it has to make an independent determination as to whether it is getting its money's worth, whether a public purpose is being furthered and whether or not the public purpose is worth the amount being spent. When one goes through the tax system, the IRS does not sit down every time somebody takes a tax deduction and make an independent determination as to whether it is interested or the Government is interested in acquiring that property. At most you have an after-the-fact, ad hoc examination of the issue.

Also, a conservation easement is different from other charitable contributions. The charity has nothing to sell. The charity does not own any property which it can dispose of for cash. The benefit for the public comes from the restrictions that are imposed on the owner's use of the land and the extent to which the charitable organization will enforce those restrictions.

Another problem that comes up in this area is the private benefit that the donor can get from a substantial tax deduction in many cases without substantially interfering with the conduct that the donor would have undertaken in any event. It has been stated that these are basically valuation issues. We think it goes beyond valuation but even to the extent that it does not, valuation is particularly difficult in this area because of the private benefit to the donor and the difficulty of determining the public benefit from the conservation easement.

Therefore, we have felt that in order to assure that we get our money's worth, to assure that there is really a public benefit here, we need a tighter definition of the types of interest and property for which a deduction should be allowed or we need some participation by Government officials to ascertain that the public interest is being served by the deduction. As precedent, for the latter I might point out section 191 of the code which deals with the historic preservation area. So we have felt that the present bill does not go far enough toward alleviating the concerns we expressed. We, however, remain hopeful that there is not that big a difference between the parties and that a satisfactory solution can be reached in the near future.

Mr. Chairman, that concludes my statement and I will be pleased to answer any questions you might have.

[The prepared statement follows:]

STATEMENT OF DANIEL I. HALPERIN, DEPUTY ASSISTANT SECRETARY OF THE TREASURY (TAX LEGISLATION)

Mr. Chairman and Members of the Subcommittee: I am pleased to have the opportunity to present the views of the Treasury Department on the ten bills being considered by the Subcommittee today. I have attached to my written statement an appendix that summarizes our position on each of these bills.

H.R. 4498 AND H.R. 5798: TAX CREDITS FOR REFORESTATION

H.R. 4498 and H.R. 5798 would provide non-refundable tax credits for different types of qualified forestry expenditures. As originally introduced, H.R 4498 also contained provisions relating to other tax and non-tax matters affecting timber but we understand these other provisions are not now before the Subcommittee.

H.R. 4498 defines "qualified forestry expenditures" as the costs of planting tree seeds or seedlings (other than for fruit or nut trees), including site preparation, and the planting and preparation for planting of "shelterbelt." Under H.R. 5798, qualifying expenditures include those for creating and enhancing vegetation on forest lands for the purpose of forest growth and quality, fish and wildlife habitat, soil stabilization, or outdoor recreation. Under current law, all of these costs are required to be capitalized.

H.R. 4498 provides that in order to be eligible for the credit, (1) a taxpayer must own at least 25 acres of land suitable for the production of timber usable in the manufacture of wood products (H.R. 5798 requires ownership of only 10 acres capable of producing crops of industrial wood or providing other forest resources), (2) the qualified forestry expenditures must be incurred with respect to at least one acre of land (H.R. 5798 requires expenditures with respect to at least 10 acres), and (3) the taxpayer must not have received or expended any cost-sharing funds under section 4 of the Cooperative Forestry Assistance Act of 1978. 16 U.S.C. Sec. 2103. (Amounts received under this section of the Cooperative Forestry Assistance Act are excludable from gross income for federal income tax purposes under certain conditions.)

The credit under H.R. 4498, which may be applied dollar-for-dollar against the first $25,000 of tax liability and may offset 90 percent of tax liability in excess of $25,000, is equal to the greater of 25 percent of qualified forestry expenditures, up to level of $50,000 in expenditures, or 10 percent of qualified forestry expenditures. This means, in effect, that taxpayers would obtain the 25 percent credit on the first $50,000 of expenditures, no credit on expenditures between $50,000 and $125,000, and a 10 percent credit on expenditures above $125,000. (The bill currently provides a $5,000 limit on the expenditures subject to the 25 percent credit, but we understand this was a typographical error.)

H.R. 5798 provides a decreasing percentage of credit as follows:

Qualified expenditures		Percentage credit
Over—	Up to—	
$1	$5,000	75
5,000	15,000	50
15,000	25,000	25
25,000	50,000	10

The graduated rate of credit in the bill results in an effective credit, taking all expenditures into account, of:

Total expenditures:	Amount of credit and percent	
$5,000	$3,750	(75)
$15,000	$8,750	(58)
$25,000	$11,250	(45)
$50,000	$13,750	(27½)

The credits provided in each bill would be effective for taxable years beginning after the date of enactment.

We estimate the revenue loss from the tax credit in H.R. 4498, based on a conservative estimate of the amount expended per acre in reforestation, will be approximately $8 million for fiscal 1981, $19 million for fiscal 1982, $22 million for fiscal 1983, $24 million for fiscal 1984 and $26 million for fiscal 1985. Of this amount, more than half will be attributable to industrial rather than nonindustrial expenditures. With respect to H.R. 5798, we estimate the revenue loss will be approximately $9 million for fiscal 1981, $23 million for fiscal 1982, $26 million for fiscal 1983, $2[illegible] million for fiscal 1984, and $28 million for fiscal 1985.

While we recognize that the level of reforestation on certain privately owned land may not be entirely adequate, the Treasury Department is opposed to the tax credits proposed by these bills.

The issues raised by these bills are subsidy, not tax policy, issues. Neither bill addresses the tax policy questions of how the basic rules of income tax accounting should be applied to land suitable for forestry, or to the structure of tax rates applicable to corporate or personal taxpayers contemplating entry into forestry activities. Rather, these bills are strictly concerned with subsidizing reforestation and associated uses of land under a program funded by credits against income tax otherwise due.

The objective of both bills is to encourage the reforestation of small parcels of land, and the incentive proposed is basically a government sharing of certain of the costs that would be incurred by a landowner (or lessee) who desires to establish a forest. The incentive-effectiveness of each proposal therefore depends on the amount of cost-sharing to be provided by the government and on the relative importance of this amount to the total cost of establishing and holding to maturity sufficient acreage to qualify as "forestry." To evaluate this relationship, it is necessary to describe the forestry process,[1] and to take note of the already considerable subsidy to timber growing provided in the tax laws.[2]

Forestry falls within that class of economic activity in which the entrepreneur makes investments over a span of years in the expectation that the resulting asset—standing timber in this case—will have a future market value sufficiently high to reward the investor for holding the capital invested. Although the technology of forestry differs from other developmental types of economic activity such as mining, real estate development, and product innovation generally, the rationale of the investment is the same: the investor decides whether to devote disposable resources (current after-tax income or previously accumulated savings) to an endeavor on the basis of a calculation of whether the expected after-tax return is high enough to justify the commitment of resources.

The normal tax treatment of investments in developmental projects is simply that all costs incurred from the outset of the project—land preparation and planting in the case of forestry—are "capitalized" and recovered as deductions from gross income when the resulting product is sold. That is, if an investor spends $1 today in clearing land and planting trees, it is assumed that the investor has made a rational decision that the cleared land planted with trees is worth at least $1, the price paid for the assets. Then, during the 25 to 30 years the trees are growing, the investor will make additional expenditures for insect and fire control. Finally, the trees are sold or cut for further processing, at which time the taxpayer "recognizes income" and deducts the capitalized costs, paying income tax on the earnings thus computed. From the investor's point of view, the investment outlays along with the future tax liability are "costs" of the net income to be realized.

As a result of the 1944 enactment of sections 631(a) and (b), which defined income from timber-cutting to be capital gain, and certain judicial and administrative interpretations of the law which permit current deductions for expenses incurred before the trees are cut, the normal costs of growing timber have been severely reduced. For the type of forestry operation described in a recent Treasury study,[3] the subsidy provided is estimated to be just over 43 percent. That is, had Congress appropriated a direct subsidy equal to 43 percent of each dollar expended by an investor in establishing a forest and simply continued to apply normal income tax accounting rules, the result would be the same as under current law. Of course, this estimate of the subsidy equivalent for these special tax provisions for timber reflects the tax status of large corporations, the entities most likely to engage in commercial forestry. For individual landowners, those subject to a 35 percent marginal tax rate for example, the subsidy provided through the tax laws is somewhat less, about 38 percent. This follows because the inherent characteristic of most tax subsidy programs is that the value of the subsidy depends on the tax rate otherwise applicable to an entity.

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[1] The forestry process is described in some detail in "Federal Tax Policy and Recycling of Solid Wastes," a Treasury Department report submitted to the Congress in February 1979.

[2] Timber growing is favored under the tax laws in three significant ways.

First, under current law, a taxpayer may elect to treat the cutting of timber as the sale or exchange of a capital asset. Thus, the revenue from the sale of timber is taxed at preferential rates while the revenues of other product manufacturers and producers are taxed as ordinary income. Taxation at capital gain rates reduced the taxes of the industry by an estimated $350 million in 1978.

Second, costs incurred in connection with growing and carrying timber (after planted trees have become established) are currently deducted against ordinary income. These costs represent up to approximately three-fourths of the total cost of growing timber. This is in contrast to the general principle that an expenditure is not currently deducted if it is related to the purchase or production of an asset that will provide a benefit beyond the year the expenditure is made. Thus, plant and equipment costs are depreciated over the periods these assets are used in a business. Similarly, the cost of producing inventory for resale is not currently deducted but is reflected in income as an offset against the selling price of the goods in the year of sale.

Timber growing currently enjoys significant exceptions from this basic tax principle. For example, timber stand improvements such as brush control, thinning, pruning and shaping of trees, and costs incurred in controlling insects and disease, are treated as annual expenses although the amounts paid for these activities add to the long-term value of the timber. If the increase in the value of standing timber is not recognized until the timber is sold or cut, then, under general tax principles, the costs of earning that income should be capitalized so that income and expense are properly matched.

The third element of the current timber subsidy is the conversion of ordinary income into capital gains. This conversion is a result of the first two subsidies described above: capital gains treatment of timber income and the current expensing of the costs of growing and carrying timber. Such expenses are currently dedudcted against other ordinary income of the timber grower, such as from logging or other business (or personal) activity while the revenue ultimately produced by these expenses—the sale of timber—is taxed at the capital gains rate. The effect is as if the cost of the purchase of securities was currently deducted against wage income while the capital gain treatment on sale applied not only to profit but to nearly the entire proceeds of the sale.

In addition, timber growing receives special treatment under the Internal Revenue Code provisions relating to the minimum tax on tax preference income. The 1976 charges to the mnimum tax for corporations increased the minimum tax rate from 10 to 15 percent and eliminated both the carryover of regular tax as an offset to future preference income and the $30,000 exemption from the minimum tax. Timber was not subject to these changes, and we estimate the revenue loss from this special treatment to be $20 million.

It is in this context that it is appropriate to consider the cost and effectiveness of the subsidies proposed by these bills. Assuming that the expenditures eligible for credit under the proposals are about $83 per acre, then for each 10 percentage points of credit allowed, the prospective large corporate investor would experience a 5.4 percent reduction in the lifetime costs of planting and holding an acre of forest, while the individual landowner subject to tax at 35 percent marginl rate would experience a 4.9 percent reduction in lifetime costs. This is the incentive effectiveness of the proposals.

On the basis of data reported by the Council on Wage and Price Stability to the Joint Economic Committee in 1977, a crude estimate of the response to such an investment incentive is that, for each percentage point reduction in costs, acreage would be increased by somewhat more than 0.25 percentage point. If a 10 percent credit for presently capitalized reforestation outlays reduces costs by 5.4 percent, then in the long run, acreage would be increased by about 1.5 percent. If we assume $83 per acre is the proposed credit base, then with a 10 percent credit, a total of 1.015 acres will be planted for each acre that would otherwise be planted, with a budgetary impact of $8.42 ($83 × 1.015 × 0.10). Thus, for each $8.42 of subsidy per acre of forested land, 0.015 additional acres of forested land will be gained.

This works out to a total national cost of nearly $600 per additional acre planted each year on private lands, hardly an efficient allocation of resources when the private cost of reforestation is only about $83 per acre.

This subsidy is in addition to the already substantial tax subsidies provided to timber growing. The effect of the current subsidies may be characterized as providing a negative income tax to the timber grower. As a result, an investment which is unprofitable before taxes may yield an after-tax profit equal to the net tax savings.[4] Thus, whatever the problems associated with lack of reforestations, they certainly cannot be said to arise from an excessive Federal income tax burden.

We are currently working with the Department of Agriculture to study the issues involved and the need for a program of reforestation. The President recently noted this undertaking in his statement of policy transmitted to the Congress pursuant to the Resources Planning Act. We are also reviewing the effect of the incentives under current law. Accordingly, in light of the current substantial tax subsidies provided timber growing and the questionable cost-effectiveness of these tax credit proposals, we do not believe it is appropriate to grant another tax subsidy to timber growers before considering the broad range of concerns relating to the production of timber in this country.

H.R. 5719: TAX TREATMENT OF PROCEEDS OF CERTAIN BINGO GAMES

H.R. 5719 would amend section 513(f) of the Internal Revenue Code, which was added in 1978. Under that section an exempt organization (or political organization described in section 527) will not be subject to the unrelated business income tax on proceeds from the conduct of a "bingo" game if the game is carried on in a jurisdiction where (1) bingo is not ordinarily carried out on a commercial basis, and (2) the conduct of bingo by exempt organizations does not violate applicable state or local law. H.R. 5719 would exempt bingo income where, although state or local law renders bingo unlawful, such law is not "generally enforced" against exempt organizations. The Treasury opposes H.R. 5719.

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[3] *See* footnote 1.

[4] For example, suppose that an investment in timber requires cost of $200 to produce $200 of timber income. This investment yields zero profits before taxes and if income and expense are properly matched, no taxes should be paid and the investment results in zero profits after taxes. However, if an investor in the 50 percent tax bracket can deduct $200 of expenses against ordinary income, he achieves a tax savings of $100. His gain on the later sale of timber is $200, but if the gain is taxed at a capital gains rate which is one-half his ordinary tax bracket, the tax on the sale is only $50. The combination of an ordinary deduction and later capital gains has permitted the investor to pay net taxes of minus $50 on the investment. As a result, the investment which was unprofitable before taxes yields after-tax profits of $50 equal to the net tax savings.

In general, it is appropriate to confine the exemption from Federal income tax for proceeds of bingo games to instances in which conduct of the bingo is consistent with local law. It seems undesirable to exempt from Federal tax the proceeds of unlawful activity. H.R. 5719 appears to accept this premise but provides that illegality be determined by the conduct of law enforcement officials rather than the law as it appears on the books. For example, it is difficult to know what the standard for "general non-enforcement" would be. Would it extend to situations where no prosecutions had been brought for a year, for five years, or what? Moreover, in cases involving a state, rather than a local law, and where prosecutorial discretion was largely left with the district attorneys in different localities, there might be instances in which the prosecuting attorney in one or more counties did enforce the State law but prosecutors in other jurisdictions did not. Consequently, H.R. 5719 would introduce significant uncertainty into the administration of this provision. The Treasury therefore opposes H.R. 5719.

H.R. 6935: REFUNDS OF TAX ON CERTAIN STATE TROOPERS' MEAL ALLOWANCE

H.R. 6935 would permit refunds of income taxes paid on meal allowances received by certain state police officers and, in some cases, would allow such refunds even if otherwise barred by the statute of limitations.

In November, 1977, the Supreme Court decided *Commissioner* v. *Kowalski*, 434 U.S. 77 (1977), holding that meal allowances paid by New Jersey to its state troopers are includible in income. This decision affirmed the long-standing IRS position, which had required states to withhold income taxes from troopers' meal allowances. Prior to the *Kowalski* decision, many New Jersey troopers (as well as some in other states) had asserted either that the allowances were not income, or deducted the amount of the allowances as employee business expenses, and accordingly claimed refunds.

Late in 1978, Congress decided that *Kowalski* should apply prospectively only, despite the facts that the troopers had been continuously aware that the IRS was contesting the issue, that income tax had been withheld on their meal allowances, and that they had been advised by their own association in 1974 to set aside money to pay the taxes if the Supreme Court sustained the IRS position. However, the legislation which was enacted (Section 3 of Public Law 95–427, October 7, 1978) generally provided relief only to those troopers who had on their tax returns effectively excluded the meal allowances from tax. As was recognized at the time, this was unfair to those troopers who had followed the IRS position and paid tax on the meal allowances.

Now the latter group of troopers seeks the relief denied them in 1978. Since it would be inequitable to discriminate against troopers who followed the law, we do not oppose the principle of this legislation. However, the bill as drafted would open the statute of limitations and permit refund claims for the years 1970 through 1977. This is broader relief than was granted in the 1978 legislation and would raise significant administrative problems.

The purpose of this legislation is to cure a defect in the 1978 legislation, not to broaden it. Accordingly, we suggest that the bill be modified to permit refunds to be claimed by individual taxpayers only for those taxable years which are still open (because of a waiver or extension of the statute of limitations, or otherwise) on the date of enactment of the prior bill (i.e., October 7, 1978). Affected taxpayers would be given a reasonable period in which to file the refund claims they would have been entitled to file in 1978. With this change, the Treasury would not oppose the legislation.

H.R. 7263: TREATMENT OF CERTAIN NONQUALIFIED DEFERRED COMPENSATION PLANS FOR NONRESIDENT ALIENS

H.R. 7263, relating to retirement and similar plans maintained for non-resident aliens, addresses issues which have gained an increasing amount of public attention because of legislation, regulations, and rulings by the Service during recent years. There is also an increased use of unfunded pension commitments, a system which with few exceptions has been specifically outlawed by ERISA as it applies to U.S. plans.

Treasury generally supports this bill.

The basic issue is whether the U.S. tax treatment of contributions to foreign pension plans maintained for non-resident aliens should be the same as the treatment given contributions to U.S. pension plans.

This issue arises in two contexts. First, foreign income may be directly taxed by the United States as in the case of a foreign branch of a United States company, certain foreign operations connected with a U.S. trade or business of a foreign company, or through subpart F of the Code which treats certain income of controlled foreign corporations (CFC's) as earned by U.S. shareholders. The U.S. must determine whether and how such income should be reduced by costs attributable to foreign pension plans. Second, for foreign subsidiaries the amount of foreign pension expenses is important in determining the amount of foreign taxes which may be creditable against the U.S. tax. This involves a determination of the portion of the "accumulated profits" of the subsidiary which were distributed to the U.S. corporate shareholders. In determining the portion distributed, it is essential to know the total "accumulated profits" which in turn depends upon the amount of pension expenses which can be taken into account.

Code section 902 is designed to avoid international double taxation on profits of a foreign subsidiary owned by more than 10 percent corporate shareholders. The U.S. shareholder is deemed to have paid a portion of the foreign income taxes equal to the portion of the "accumulated profits" of the subsidiary which were distributed. Accumulated profits has consistently been viewed in terms of United States rather than foreign tax standards.

Whether contributions or accruals to foreign pension plans reduce accumulated profits will in most cases depend on whether the "U.S. standard" applied is the general tax accrual standard or, alternatively, the special U.S. tax standards under section 404 for contributions to employee deferred compensation plans.

One significant feature of the United States system is the requirement for actual cash transfers. No deduction is allowed for accrual of liabilities, even in cases where all events have occurred which fix the liability to a specific beneficiary and the amount of the liability is know. There are two considerations supporting this rule generally. First is the belief that the security of the promised benefit requires a transfer of funds to an independent fiduciary to be held for the exclusive benefit of employees and retirees. Employees should not have to compete with general creditors of the employer. Secondly, because the employee is on the cash method, if general accrual rules were followed there would be a substantial mismatch in the time of the deduction by the employer on the accrual method and the taxation of the benefit to the employee. Section 404 is designed to eliminate this mismatch except in the case of qualified plans which serve the public purpose of benefitting a broad cross-section of employees.

Of course, with respect to non-resident aliens working outside the U.S. the latter concern is not relevant since they would not be paying a United States tax on their income. With respect to the first concern, other nations have reached conclusions for their own residents which differ from ours. For example, Germany and many other other countries have chosen a pension system designed to increase capital investment in the employer. These countries have created rules strongly favoring accrued but unfunded pension obligations, supported by a separate insurance system to protect retirees against unanticipated business declines.

It seems inappropriate for a United States rule to be applied worldwide to foreign persons not resident in the U.S. particularly in the face of different judgments reached by other countries. It is clear that our tax rules are at issue here rather than ERISA generally; the general funding requirements contained in Title I of ERISA (and thus generally applicable whether or not a plan is tax qualified) are subject to an exclusion for plans maintained outside of the United States primarily for the benefit of persons substantially all of whom are non-resident aliens.

There are in addition other issues which arise even when there is separate funding. Under section 404 such cash transfers would not be deductible unless either the plan was qualified or specific employees had a vested interest in the amount contributed. There are certain exceptions to the strict qualification standards. Minimum standards for participation in qualified plans need not be applied with respect to employees who are non-resident aliens having no U.S. income.

Furthermore, the general principle which prohibits discrimination regarding contributions or benefits in favor of officers, shareholders or highly compensated individuals, can be applied without consideration of employees who are nonresident aliens. However, there are many other provisions which could prevent a plan from meeting the appropriate standards for qualification and therefore deductibility even though all participants were non-resident aliens. Such provisions include, for example, the requirement for joint and survivor annuities, vesting rules contained in section 411 and the merger and consolidation rules aimed at protecting the integrity of plans involved in mergers or spin-offs.

Even assuming that each of these other qualification standards apply and are met, section 404 contains an elaborate set of special deduction rules which also have underlying social goals to some degree. The deduction rules with respect to profit sharing plans are more restrictive than the deduction rules with respect to money purchase plans or pension plans. Because of this difference the system favors certain plans, i.e., those which do not have the discretionary contribution element of a profit sharing plan. Furthermore, special deduction limits apply to plans maintained by proprietorships, partnerships and Subchapter S corporations. With respect to defined benefit plans the annual cost of the plan must be measured in accordance with the actuarial rules used by the plan to satisfy the minimum funding standards under section 412. The section 412 rules have been designed to some extent with the specific purpose of denying certain actuarial methods which, although arguably accurate in their ability to measure and allocate plan costs between separate accounting periods, leave the employee in a more precarious position with respect to the adequacy of the funding of the plan.

We see no reason to compel a foreign subsidiary or a foreign branch employing non-resident aliens to comply with those U.S. deduction rules that are motivated by U.S. social policy concerns rather than general U.S. tax policy with respect to the appropriate calculation of taxable income for the period. It may, in fact, be frequently impossible for a foreign subsidiary or branch to comply with the U.S. rules because it may be bound by different rules of the jurisdiction in which it is incorporated or operating.

Thus, the bill permits both branch and foreign subsidiary operations to use rules which approximate normal accrual rules for plans benefitting employees substantially all of whom are nonresident aliens. Thus, accumulated profits, earnings and profits, and taxable income may be reduced because of an accrued pension benefit so long as the obligation is absolutely and clearly fixed, even though a separate fund is not set aside.

With respect to those plans which are in fact separately funded a deduction is allowed under the bill for the amount set aside to the extent that it reasonably relates to the benefit promised and to the extent that the fund is not subject to reversion to the employer. The deduction is permitted whether or not the plan meets the detailed qualification standards of section 401 and whether or not the benefit is fully vested in the employee at the time the money is transferred. Of course, in both the unfunded and funded situation we believe that it is necessary to limit the deduction to amounts calculated under acceptable actuarial methods pursuant to generally accepted standards.

Treasury approves of the use of limits referring to general accepted accounting standards applicable to U.S. businesses. Using those standards avoids additional complex computations; the generally accepted accounting principles are already applied by the domestic parent corporation in developing consolidated financial statements. Generally accepted accounting principles for pension expenses are currently based upon the Accounting Principles Board Opinion No. 8, promulgated in 1968. The Accounting Principles Board is at present underway in a study which may revise the rules. However, there is no indication that such revisions would move away from the basic concepts of continuity and an appropriate recognition of expenses attributable to each period based on a recognized actuarial methods. These principles apply whether or not cash is actually transferred to a separate fund. These rules also have an explicit provision prohibiting the immediate charge to expense for new increments of past service liability, which is one of the primary aspects of the detailed section 404 rules which aid in the appropriate measurement of taxable income.

Notwithstanding our interest in avoiding conflicts between U.S. and foreign tax systems, and the international double taxation that frequently results from such conflicts, we believe it would be unwise and unnecessary to modify H.R.

7263, as has been suggested by some persons, to determine the deduction with respect to foreign pension plans with specific reference to the amount deductible under the foreign income tax system. It is a matter of long standing U.S. tax policy that determinatons of U.S. tax liability should be based on U.S. standards rather than be dependent upon the ups and downs of foreign law. Reliance on foreign law would create a shifting standards of U.S. tax liability, dependent upon the incentives or disincentives of different countries. A further problem with relying on foreign standards is that the IRS would be required to become expert in the various foreign laws controlling pension plans. It would be extremely difficult for the IRS to keep current on and fully understand all the relevant and complex provisions of such laws. Finally, reliance on foreign law in addition to U.S. law would require the further complexity of carryback and carryover provisions to account for timing differences between the two systems.

To sum up, in the case of foreign subisidaries and foreign branches we believe that more general rules should apply. These more general rules will not avoid imposing U.S. social policy on totally foreign operations but, as a general matter, will allow U.S. taxable income and accumulated profits to more closely approximate foreign taxable income thereby avoiding timing problems or permanent distortions which tend to create international double taxation of income. Although we have not completed our study of this issue, it is possible that a substantially similar result is reachable under current section 902. Thus, we would have no objection if these legislative amendments were made applicable retroactively in the case of foreign subsidiaries. However, as contrasted to the foreign subsidiary case current law controlling the determination of taxable income for foreign branches clearly disallows a deduction for an unfunded accrual or a contribution to a plan not meeting the requirements of section 404. Thus, the legislation as it affects branches is definitely a change in current law and should apply prospectively only.

H.R. 7263 contains two additional provisions which need mention. The first is an amendment to section 312 of the Code which prescribes rules with respect to the earnings and profits of domestic corporations. The second amends section 679 of the Code which provides rules with respect to foreign trusts created by United States grantors that do not explicitly prohibit benefit payments to U.S. taxpayers.

The provision regarding section 312 is apparently intended to make certain that the earnings and profits of foreign corporations are reduced in accordance with the new rules provided by section 404(i). Earnings and profits and accumulated profits rules for foreign corporations generally follow rules applicable to the computation of taxable income of U.S. persons. Consistent with this general approach, and especially in view of the clearly expressed purpose of H.R. 7263, we believe an amendment to section 312 is unnecessary. Furthermore, an explicit amendment to section 312 may raise negative inferences that other standards are used to reduce accumulated profits under present law or that earnings and profits do not, in general, follow taxable income absent a statutory provision to that effect.

With respect to the effective date of section 679, we believe that the change should be made retroactive to 1976 (the effective date of that provision) because that section was not aimed at bona fide foreign pension plans, but rather at abusive tax haven shelter trusts.

I would like to raise with the Committee two final concerns with regard to this legislation. First, as a general matter, we believe that there are other significant and unsettled issues related to the computation of accumulated profits and earnings and profits under section 902 as well as under section 964. We believe that in the course of reviewing this bill the Joint Committee staff should be urged to look closely at these related issues with a view toward developing other legislative proposals.

Secondly, we believe that in developing rules for the accrual of unfunded pension obligations where the payment is to be made substantially in the future we are moving into an area of the tax law which is somewhat unique. Because of the substantial deferral, the bill explicitly requires that the current accrual deduction measure the present value of the final benefit. This concept provides an appropriate matching of income and expense. In essence this provision charges to this year's expense a portion of the final pension payment, and charges to future years the remainder of the total payment. Although there are many ways of characterizing the amount, the difference between this year's charge and the total payment might be viewed as an increase in the amount to be paid as result of the deferral of the payment beyond the current year, i.e., the year in which the benefit was actually earned.

The concern which we wish to raise regards the appropriateness of permitting this additional deduction over the remaining years in those cases in which the current accrual is actually set aside by the employer in a separate investment, which itself produces income that is either tax free or substantially tax free to the employer. For example, assume that the amount set aside in this year is $100 and that the benefit that this $100 will provide in 20 years will have a value at that time of $320. Under normal circumstances where the $100 remains invested in the working assets of the business that $100 produces income for the employer, and such income is included in the employer's taxable income. Thus the increasing obligation as a result of the deferral is rightfully treated as an additional deduction. However, if the employer, who for this example we would assume to be a United States corporation, were to invest that $100 in the stock of some other United States corporation and receive dividends thereon, the applicable U.S. tax law would provide that those dividends are either totally excluded from income or subject to an 85 percent dividend received deduction.

The question we raise is whether under such circumstances it is appropriate to continue the deduction with respect to the amount to be paid to the employee in excess of the original $100 accrual. If the employer were to choose to separately fund his obligation to make the pension payment the $100 would have been placed in a separate trust, and neither the income earned thereon nor the payments by the trust to the employee in excess of the original $100 contribution would be accounted for in the employer's income tax return. This result is, of course, different from the result obtained by the employer who is able to make a tax preferred investment and yet claim a full deduction for the total payments made to the employee upon retirement. Under that circumstance the deduction is not offset by added taxable income.

We have no specific conclusions that can be applied without undue complexity. We therefore do not urge that the bill be delayed, but we will continue to study this issue. We also urge others to do so. We may come back to this issue if it appears to be a serious problem or if a workable solution is developed.

There is another matter relating to foreign pensions which the Subcommittee may wish to consider, although it is not directly related to H.R. 7263. Section 871(f) currently provides an exclusion for annuity income received under a qualified annuity plan by nonresident aliens if (1) substantially all of the services for which the annuity is paid were performed outside the United States and (2) at the time the first payments were made under the plan, at least 90 percent of the participating employees were U.S. citizens or residents. The Senate Finance Committee reported an amendment (section 407 of H.R. 1212) during the last session under which the 90 percent test would not have to be satisfied if the recipient's country of residence either grants a reciprocal exemption to U.S. citizens or is a "beneficiary developing country" under section 502 of the Trade Act of 1974.

The Treasury Department does not oppose such an amendment, subject to minor technical comments. Nothing in the existing provision or its legislative history indicates any legal or policy rationale for the 90 percent requirement. Furthermore, the revenue impact is insignificant.

H.R. 7276: INVESTMENT CREDIT FOR REHABILITATED BUILDINGS LEASED TO TAX EXEMPT ORGANIZATIONS AND GOVERNMENTS

The Code geneally disallows the investment credit for property used by certain tax exempt organizations and governmental units, including property that is both "owned by" and "leased to" an ineligible organization. H.R. 7276 would amend these rules to allow the credit for the costs of rehabilitating a pre-existing building, a feature of the investment credit added by the Revenue Act of 1978, even though the building is leased to a tax exempt organization or governmental unit. The Treasury opposes H.R. 7276.

Since enactment of the investment credit in 1962, the credit has been unavailable for property used by exempt organizations and governments. Among other things the Congress felt that investments by such organizations should not be subsidized because they would not be responsive to the stimulus of the credit. We see no reason why investments to rehabilitate buildings should be treated any differently than investments in other property for which the investment credit is otherwise allowed.

Alternatively, it could be argued that the investment credit functions in part to offset taxes on income from capital, including separate taxation of corporate income. If so, the credit if not neded in the case of exempt organizations and governments which are not subject to tax in any event on capital income, and H.R. 7276 could not be justified on this ground.

In short, whatever the underlying theory of sections 48(a)(4) and 48(a)(5), they apply with equal force to all property eligible for the investment credit, including the rehabilitation credit. The Treasury therefore opposes H.R. 7276.

H.R. 7318: DEDUCTION FOR CONTRIBUTIONS OF CERTAIN INTERESTS IN PROPERTY FOR CONSERVATION PURPOSES

H.R. 7318 is the second bill to be considered this Congress dealing with deductions for charitable contributions of conservation easements. In general the Code, subject to certain exceptions, denies deductions for contributions of less than the contributor's entire interest in the contributed property. One exception is for certain interests, such as easements and remainder interests, granted "exclusively for conservation purposes." H.R. 7318 would revise, and in some respects liberalize, the conservation interests exception and eliminate the 1981 sunset date to which it is currently subject.

The predecessor of H.R. 7318 was H.R. 4611, on which the Treasury testified on November 9, 1979. (A copy of our prior testimony is attached.) At that time we expressed serious reservations about that bill. We have, since that testimony, kept an open mind on the issues raised by this legislation and have made substantial efforts to reach an accommodation with its proponents. Ultimately, we do not feel that H.R. 7318 is significantly more responsive to our concerns than was H.R. 4611, although we continue to believe that it could be altered to alleviate those concerns.

Among other things, H.R. 7318 fails (1) to provide a sufficiently precise definition of "conservation purposes," and (2) more generally, to insure that contributions of interests, such as easements, for which deductions are allowed will be confined to those that provide some benefit to the general public and will be enforced and managed in a way that furthers that benefit. These deficiencies might be remedied in several ways, which I will discuss later, including tightening the statute, or providing for involvement of responsible public officials in the determination of eligible interests, or some combination of these approaches. However, the deficiencies are significant and, unless some way is found to alleviate them, we would continue to have reservations about H.R. 7318.

Our concerns can best be understood in the context of an examination of both the alternatives to allowing deductions for contributions of these interests and the nature of the interests themselves. In discussing these issues I would like to focus attention on the contribution of the so-called "conservation easement," because we believe that it raises the most significant policy questions. In such a case the contributor retains the right to use and enjoyment of the property burdened by the easement and merely "covenants" not to use the property in particular ways, typically not to develop it.

We acknowledge the importance to those whose mission is the conservation of our national land resources of the use of easements in real property. Land owners may be reluctant to part with title to their property. The acquisition by Federal or state governments, or by responsible charitable institutions, of easements against development may be an attractive alternative to acquisition of the fee. Such easements may protect the land burdened by the easement, or may augment the protection of land already acquired. As part of its land acquisition policy we understand that the Department of Interior often has acquired conservation easements rather than fee simple interests and we assume that state and local agencies have done likewise. Thus, it must be recognized that the acquisition by purchase of conservation easements can be, and in fact frequently is, a technique of land preservation currently used by agencies with responsibility for conservation of land resources.[5]

Facilitating the acquisition of conservation easements through purchase would insure that responsible public officials would have consciously decided whether an easement with respect to a particular parcel of real property would serve the public interest. Moreover, where an easement is acquired through arms-length negotiation between a government agency and the private landowner the bargaining process will tend to insure that the government receives fair value for its outlay. Thus, where easements are acquired through government purchase protection of the public interest tends to be self-enforcing.

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[5] The General Accounting Office recently has released an extensive study that is critical of the Department of the Interior's land acquisition program. Among other things, the study expresses the view that too much land is acquired in fee simple and recommends that alternatives to fee acquisition, including easements, as well as local zoning and Federal land controls, be carefully considered.

Different considerations may apply with easements acquired by contribution. To be sure, where an accurately valued easement covering lands of established significance is contributed to an established and qualified resource manager, the public benefit also may be served. However, in many instances involving contributed easements it may be far more difficult to ascertain that the public in fact is securing a benefit or that fair value is received in return for what the government is paying indirectly through the tax system. There may be significant questions concerning the worth of the easement in terms of legitimate conservation interests or the ability or willingness of the recipient to manage the interest conveyed.

These problems are materially more difficult where transfers of certain kinds of partial interests in property are involved than they are with outright gifts. The recipient receives the full use of an outright gift. Assuming it is acting in furtherance of its recognized exempt purposes, the gift can be devoted to those purposes. Alternatively, the contributed property could be sold and the proceeds devoted to the charity's activities. Indeed, even with gifts of certain partial interests such as remainder interests, sooner or later the property will be available for use by the charity. In such instances, assuming the charity has properly been recognized as exempt, the nature of the recipient itself tends to assure that the contribution will serve an exempt purpose.

Compare this with the interests in property for which a deduction would be allowed by reason of this H.R. 7318. In many such instances the receipt of the interest does not, as such, ensure that a charitable purpose is being served. Whether it is will depend entirely on the nature of the particular interest conveyed. For example, one feature of H.R. 7318 would allow transfers of land to a charity with the transferor retaining subsurface oil, gas or other mineral rights. Although this is limited to cases where "surface extraction" is prohibited, we understand that "surface extraction" does not include surface stations such as derricks or pumps used to explore for or extract oil or natural gas. Thus, under H.R. 7318, an oil company could secure a deduction for contribution to a charity of the surface rights to a tract of land that was littered with oil derricks and pumping stations, while retaining all rights to drill for and extract the oil. We question whether a charity would be able to realize much value from such a gift.

Where an easement is transferred to a charity, the problem will be more acute. The transfer will be of benefit to the public only if (1) the nature of the restrictions imposed by the easement on the particular land that it burdens will themselves provide some ascertainable public benefit, and (2) those restrictions are enforced after transfer. Certainly if responsible government officials were involved in the acquisition of easements we are confident that they would acquire only those that provided some genuine public benefit. For example, where the owner of beachfront property grants an easement with respect to the beachfront it may be difficult to say, absent public access to the beachfront, that a public purpose has been served by the contribution of the easement. Where oceanfront lands, such as the Cape Cod National Seashore, have been acquired by the government, the public generally has been allowed access.

It is essential that H.R. 7318 be revised so that it, too, is focused on situations where there is confidence that some public benefit will result. This need for a more refined focus is intensified by the substantial private benefits that can flow from deductions for contributions of conservation easements, often without any true current cost to the donor, and the difficulties of policing aggressive and abusive valuations.

Obviously the charitable deduction creates a powerful incentive whose value, unlike the proceeds of an easement that is sold, rises with the marginal tax rate of the contributor. This incentive may be specially appealing in instances where the landowner's enjoyment of the land is essentially unaffected by the contribution. For example, the oil company, described hypothetically above, that owns land on which it is actively exploring for or extracting oil or natural gas, has not foregone anything of substantial value to it if it transfers the surface rights while retaining all preexisting rights to explore for and extract the oil. The transfer results in no impediment to the transferor's principal interest in the land.

In other instances the contributor of an easement may be foregoing valuable rights, but ones the contributor did not expect to capitalize on for years. In such instances the contributor may receive substantial tax benefits simply for forbearing from doing something they did not, in any event, have any current intention of doing. Thus, the owner of a personal residence located on a substantial parcel of land on the Chesapeake Bay that had been in the family for generations might well expect to continue to use the land as a residence; but, under H.R. 7318, that individual might nevertheless secure a substantial income tax deduction for contributing an agreement not to develop the land. Perhaps the answer to such a situation lies in accurate valuation of the easement. But we note that in other circumstances where a charitable contribution would not affect the donor's current enjoyment of property—contributions of remainder interests in art—Congress chose instead to disallow any current income tax deductions.

Indeed, we think it may be asking too much to suggest that all of these issues can be handled by precise valuation. There well may be more significant opportunities for aggressive and abusive valuation of interests such as easements than there are with other contributions. Where a person donates to a charity tangible personal or real property with outright title passing to the recipient, valuation frequently must be based on appraisal. However, access to information on the prices at which comparable items have been exchanged in the open market tends to provide some evidence on the basis of which to make the appraisal. Fairly accurate estimates may also be made of income and remainder interests in property.

Contributions of partial interests such as easements may, for both practical and conceptual reasons, be more difficult to value. In general, as with a charitable contribution of a parcel of property, the starting point for valuing the contribution of an easement would be the appraised value of the property. However, assuming the transferred interest were valued using so-called "before and after" valuation—which seeks to compare the value of the property before the contribution with the value of the property after the contribution—a certain amount of what is essentially speculation must be indulged. The appraiser must try to ascertain what the hypothetical value of the property would be assuming it was burdened by the easement. Except in areas where land was widely subject to easements and a market was established in burdened land, the appraiser would have to speculate at the diminution in value worked by the transfer of the development rights. Thus, simply as a practical matter, it may be far more difficult to police aggressive valuation of easements than it is with outright contributions of land.

There also may be conceptual problems in allowing a deduction for the contribution of an easement based on the full reduction in value of the land. The value of rights to develop real property, when held in conjunction with fee title to the property, may be greater than the value of the mere right to prohibit development that is frequently transferred through an easement. Since the recipient is not in a position to realize the developmental value, what the recipient receives may be less valuable than what the transferor has given up. Moreover, even assuming that, for purposes of the charitable contribution deduction, the value to the recipient should be considered to be equal to the value of the rights foregone by the transferor, it may in valuing those rights be difficult to take account of the likelihood that the property in fact will be developed or the time that may lapse between the date of transfer and the time of development.

In short, the valuation process may not be sufficiently refined or precise to take account of all difficulties in valuing easements. This fact, when combined with the substantial incentive to aggressive valuation, underscores the need for ensuring that the public secure some tangible benefits from the contribution of easements for which deductions are permitted. We do not suggest that no public benefit will be derived from the contribution of easements; only that, in some instances, the grant of the easement may produce substantial private benefits that are not reflected in the value of the contributed interest and which in some instances may serve no real public purpose. This problem may be particularly troubling where there is no governmental involvement in selection of lands for which easements will be acquired.

It is because of these combined concerns for public benefit, private gain at little private cost, and inaccurate valuation, from indirect funding of conservation easements that we continue to feel that existing law should be revised to assure that the public's interests in fact will be served. One method would be to confine the deductibility of contributions of easements to those covering land near areas of defined Federal, regional or state conservation interest in situations where a governmental authority or established conservation organization with land-management capabilities agrees to accept and enforce the covenant. Such an approach would permit, for example, the allowance of deductions for contributions of easements in lands that are adjacent to national parks, national monuments, and fish and wildlife refuges, or are otherwise consistent with the conservation objectives of the Department of Interior. Such an approach would in many respects serve the same purposes as does the requirement that the Secretary of the Interior or an approved non-Federal agency certify the rehabilitation of historic structures before special tax benefits under section 191 are available. Indeed, the desirability of an actual certification procedure should be explicitly considered.

A second approach to ensuring that the public benefit is being furthered, which could be employed either alternatively or in conjunction with a certification procedure, would be to narrow the existing definition of conversation purposes. In the conservation area, easements perhaps should be allowed for preservation of wildlife habitat, preservation of land of scenic value, and in other instances where the public is allowed access, but it is not clear just how much broader the list should be. While we recognize that public access does not always amount to public benefit, and while the notion of requiring public access has been criticized, some such requirement generally would tend to insure that a public benefit is being derived in return for the indirect expenditure of public funds through the charitable contribution deduction. In any event, either in conjunction with or as an alternative to certification, limiting contributions of conservation easements to situations where the public derives some identifiable benefit from the contribution seems to us to be an essential step. Without such controls there is every likelihood that substantial government funds will be expended without any corresponding public benefit.

We do not think H.R. 7318, in its existing form, provides adequate assurance that contributions of easements that would be paid for indirectly through tax deductions will necessarily be confined to those that serve some discernable public purpose. This deficiency clearly should be rectified. We and the Department of Interior look forward to the opportunity to work with the sponsors of the bill, the Subcommittee and the Subcommittee's staff, in an effort to arrive at a mutually acceptable solution.

H. R. 7392 : INFORMATION REPORTING IN RESPECT OF CERTAIN ENTERTAINMENT EXPENSES

Section 274(a) generally limits deductions for entertainment, amusement or recreational expenses. The 1978 Revenue Act amended this provision to specifically provide that no deduction is allowable for any entertainment "facility" expenses. However, a number of exceptions are provided to the general disallowance rule. One of these exceptions allows the deduction of expenses for goods, services and facilities if (1) the expenses are treated as compensation to an employee by the payor on its tax return and (2) if the expenses are treated as wages of the employee subject to income tax withholding.

The Technical Corrections Act of 1979, Public Law 96-222, provides an additional, temporary exception to the general disallowance rule. Under the Technical Correction Act change, expenses paid or incurred during 1979 or 1980 for goods, services and facilities provided to non-employees are not subject to disallowance (1) if the expenses are includible in the gross income of the recipient (a) as compensation for services rendered or (b) as a prize or award under section 74, and (2) if the amount paid is included on any information return required to be filed by the payor under certain Code provisions. Generally, these provisions require reporting of salaries, wages, premiums, emoluments, etc., if the amounts paid aggregate $600 or more. We assume that it is understood that these provisions are interpreted to require the reporting of prizes and awards if included in gross income.

H.R. 7392 would modify the exception provided in the Technical Corrections Act and would make the exception, as modified, permanent for expenses paid or incurred after December 31, 1980.

The bill would continue to provide that the exception is available only if the payor treats the expenses as either compensation for services or as a prize or award under section 74. However, the exception would not apply if the expenses are required to be, but are not, included in an information return, or would be included in an information return except that the amount of the expense is less than $600.

We do not object to H.R. 7392. However, we would prefer a broader approach to the information reporting requirements. Specifically, we believe it is appropriate to require reporting to the recipient as well as to the Internal Revenue Service. Further, we believe it would be appropriate to substantially increase the sanctions imposed for failing to provide information returns in order to increase compliance in this area.

H.R. 7487: EXCISE TAX ON LIGHTER GAUGE STEEL DRUMS

H.R. 7487 would impose an excise tax of 20 percent on the sale by the manufacturer or importer if light gauge steel drums, that is, drums with a body lighter than 18 gauge sheet steel and with a capacity of at least 35 but not more than 65 gallons.

This bill is an attempt to stem the loss of business by reconditioners of barrels due to the shift by users to barrels of lighter gauge. Heavy gauge barrels are suitable for reconditioning a half dozen times or more. The lighter gauge ones can be reconditioned, but they are less likely to be reconditioned than the heavier ones.

The lighter gauge units have a lower initial cost than the heavier gauge and being of lighter weight cost less to transport. Producers whose products must be protected from all possibility of contamination must use new barrels in all cases and naturally buy the cheapest possible if they cannot economically sell them for reconditioning. Even where reconditioned barrels can be used, a producer may find that a new lighter weight barrel serves its purposes better, because it is not economical to attempt to return the barrel for reconditioning. For instance, the removal of many industrial plants in the last three decades from concentrated industrial zones presumably has increased the cost of returning a barrel to a reconditioning plant because of longer shipping distances.

The National Barrel and Drum Association, in a brief in support of H.R. 7487, estimates that this bill would, at 1977 prices, result in a tax of $3.35 on the lighter gauge barrels. This tax, when added to the 1977 average price of such barrels, would bring the price to $20 or $1.35 over the price of 18 gauge barrels. The Association estimates that 60 percent of the lighter gauge market will continue because of quality control requirements. Transportation costs are another factor favoring the use of lighter gauge barrels.

One argument advanced by the reconditioners in support of their proposal is that there would be savings in material and energy through reconditioning of the heavier gauge units. But this is not necessarily correct. While the reconditioning process reduces the need for new steel, other costs enter into the picture. For example, transportation costs from users' factories to the destination and then back to the reconditioning facility are important, and these are largely energy costs.

Another argument made in support of the bill is that there would be less pollution from the disposal of barrels and hazardous substances shipped in barrels, if the barrels were returned for reconditioning. The reconditioners are experienced in handling and disposing properly of toxic products.

An excise tax on light gauge barrels would encourage companies to switch to heavy gauge barrels which can be reconditioned, and this, in turn, would reduce the number of barrels that must be disposed of. However, taxing light gauge barrels may not be the most efficient way to reduce pollution. Instead, it may be more efficient for governments to require companies to dispose of used barrels in a proper manner.

Another possibility would be to impose an excise tax on the manufacture of all steel barrels, but permit a partial refund or credit each time a barrel is refurbished. This approach would be similar to laws requiring returnable soda bottles. At this time we do not know the extent to which the excise tax proposed in H.R. 7487 will reduce pollution or whether these benefits are worth the increased cost on businesses. However, it should be recognized that users of 60 percent of the light gauge barrels will continue to use new barrels because of quality control requirements.

H.R. 7520: TAX TREATMENT OF CERTAIN MUTUAL OR COOPERATIVE TELEPHONE COMPANIES

Under existing law mutual or cooperative electrical and telephone companies are exempt from tax if, among other things, 85 percent of their income is derived from their member-patrons for the purpose of defraying the cost of services provided to members. Legislation enacted during the last Congress provided a special exemption from the 85 percent requirement for income derived by a telephone cooperative pursuant to an interconnection agreement for long distance calls involving the cooperative's members.

H.R. 7520 would make essentially three changes to existing law. First, where an electrical or telephone cooperative derives income from the rental of right to attach wires to its poles, the revenue would not be considered in determining whether 85 percent of the cooperative's income is from members. Second, H.R. 7520 would exclude such pole rental income from the unrelated business income tax. Finally, H.R. 7520 would exempt from the 85 percent requirement income derived by a telephone cooperative from the sale of "display listings," that is listings in yellow page directories (as contrasted with normal telephone listings).

The Treasury does not oppose exempting pole rental income from the unrelated business income tax. The Treasury does have reservations about excluding both pole rental and display listing income from the computation of that portion of the cooperative's income that is considered to be derived from nonmembers.

The provision of the Code which may result in subjecting pole rental income to the unrelated business income tax was added with the Tax Reform Act of 1969. Before that Act rents from real property were excluded from unrelated business income, and rents from personal property also were excluded where the personal property was leased with real property. Under the 1969 change rentals from personal property are subject to tax even where real and personal property are rented together, if more than 50 percent of the rental is attributable to the personal property. For these purposes telephone poles are considered personal property. Thus, whether pole rentals are subjected to the unrelated business income tax depends in each instance on how much of the income is attributable to the right of way (real property) and how much to the pole (personal property), a fact that frequently is difficult to ascertain.

The rationale for subjecting exempt organizations to the unrelated business income tax is to prevent them from competing unfairly with taxable businesses. Consequently, most forms of "passive" investment income are not subject to the tax. While it is difficult to say whether income from pole rentals is similar to "passive" investment income such rentals do not appear to entail competition with taxable businesses. Moreover, existing law would yield different results for different cooperatives depending on the relative values or costs of their poles and right-of-way, a result that does not seem particularly sensible. Therefore, we see no reason why the pole rental income should not be excluded from tax.

Different concerns are involved with the 85 percent requirement that currently applies to cooperatives. While that requirement was probably designed to forestall the necessity for cooperatives to distribute all liquid reserves to their patrons, it operates to permit an exempt cooperative to earn up to 15 percent of its income from nonmember sources and apply the profits to subidize services to member-patrons. Where the 15 percent requirement is fulfilled with passive investment income the cooperative may, under the unrelated business income tax rules, derive that income free of any tax. The cooperative thereby is allowed to subsidize its patrons' cost of service with pretax rather than tax paid dollars. To this extent, member patrons of a telephone or electrical cooperative are extended benefits that are unavailable to those who purchase utility services from investor owned utilities.

We are reluctant to see the Code amended in any way that substantially enhances the ability of telephone and electrical cooperatives to subsidize the cost of services to their member patrons with tax free income. It is possible that exempting from the 85 percent requirement income from both display listings and pole rentals would have that result. This is not, as was the case with recent legislation involving long distance interconnection revenues, a situation in which it is not possible to ascertain the extent to which the revenues are derived from outside the membership. Since revenues from both display listings and pole attachments is identifiable as such we question exempting them from the 85 percent test.

To be sure, where there is an identity between the source of what is technically non-member income and the cooperative's membership—as, for example, would be the case when a telephone cooperative derived pole rental income from an electrical cooperative with identical patronage—our concerns to some extent would be mitigated. However, it is not clear to us how frequently such an identity will exist.

Our general reluctance to see the 85 percent requirement eroded is reinforced by two longer-range considerations. First, we do not think that the Congress should adopt legislation that would significantly facilitate the ability of exempt cooperatives to subsidize their patrons' cost of service with tax free dollars without reexamining the basis for the exemption itself. We understand that many exempt electrical coops have in recent years become utilities of very substantial size. We also understand that the General Accounting Office is currently engaged in a major study of the treatment of exempt electrical cooperatives. We think that study, when completed, would offer the Congress a desirable opportunity to review the continuing wisdom of this exemption.

Second, the Congress has, in recent years, moved towards a different and in our view more sensible scheme for taxing mutual benefit organizations such as electrical or telephone cooperatives. Under that scheme, which now applies to social clubs and homeowners' associations, the entity is exempt from tax on all amounts received from members but subject to tax on all income derived from outside the membership. Imposing a similar scheme on other cooperative organizations would curtail concerns for allowing cooperatives to defray the cost of their patrons' services with tax-free dollars and also would eliminate concerns about whether a cooperative has or has not exceeded the existing 15 percent limit. We believe this would be a far more sensible solution to these problems.

H.R. 7606: EMPLOYEE PLAN REVISIONS

H.R. 7606, the "Employee Stock Ownership Improvements Act of 1980," would make a number of changes in the Code provisions relating to tax-qualified plans, particularly those which invest in securities of the plan's sponsor.

Of the eight amendments proposed by H.R. 7606, we object only to the proposal, in section 8 of the bill, to repeal section 401(a)(22) of the Code.

Section 401(a)(22) was added to the Code by the Revenue Act of 1978. It provides, in general, that any tax-qualified "defined contribution plan" (a profit-sharing, stock bonus or money-purchase pension plan, including an "employee stock ownership plan"), which has more than 10 percent of its assets invested in closely-held employer securities, must allow participants to direct the plan's trustee as to how the securities are to be voted on certain major corporate matters. These major corporate matters are those that, by law or corporate charter, must be decided by more than a majority vote of outstanding common shares voted. This would generally include, for example, a decision by the shareholders as to whether the corporation should merge with another company, liquidate, or sell substantially all its assets. Participants would be entitled to disclosure of financial information and other data necessary to exercise their vote in a meaningful way.

We are opposed to the proposal in H.R. 7606 to repeal section 401(a)(22) because we believe the disclosure of relevant financial information which will accompany the pass through of voting rights in the limited situations described is an essential element in making the plan's investment in closely-held employer securities meaningful.

Investment of pension plan assets in the stock of the employer is generally inconsistent with the overall policy goals, reflected in many other Code provisions and in Title I of ERISA (the Employee Retirement Income Security Act of 1974), of providing retirement security. In effect, if a qualified plan invests in employer securities, particularly those that are not publicly traded, the employees who participate in the plan are less protected than an unsecured creditor of the employer. This follows because the value of the plan's assets—stock of the employer—depends on the net equity value of the employer's business, after taking into account liabilities to creditors. This result is inconsistent with the goal of ERISA and other Code provisions to require advance, secured funding of retirement benefits.

Investments in employer securities by defined contribution plans can only be justified on the ground that such investments will increase employee interest and productivity, which is based on the assumption that motivation will increase if employees have an ownership interest in the employer. However, to achieve this goal, the interest must be real.

We believe that for employees to have a meaningful interest in employer securities held by a qualified plan, it is essential that they have the information necessary to make judgments on major corporate issues. If they are to derive motivation from stock ownership, it is vital that the information available to owners be furnished. The ability to direct voting may be less significant where the principal shareholder has effective control, even where more than a majority vote is required, but it is an important symbol of ownership status and increases the sense of participation in the employer's business—the basic justification for allowing qualified plans to invest in employer securities. Keeping employees from being involved in major corporate issues must, we believe, result in less motivation since the interest of the employee in the employer is clearly less meaningful.

We do not object to the other provisions on this bill, which would make the following changes:

Section 2 would allow a stock bonus plan to distribute cash to participants, if the participant has a right to demand a distribution in employer securities and the "put" requirements of section 409A(h)(2) are satisfied.

Section 3 would allow the special annual addition limitations for certain employee stock ownership plans to apply where cash is contributed to purchase employer securities.

Section 4 would change the valuation date for employer securities to a tax credit employee stock ownership plan from the due date of the employer's tax return to the date the securities are contributed to the plan.

Section 5 would allow certain second-tier subsidiaries to use stock of the "grandparent" corporation in a tax credit employee stock ownership plan.

Section 6 would amend the minimum participation standards for qualified plans in the case where the only employer-sponsored plan is a tax credit employee stock ownership plan. (Although we do not object to this provision, we would prefer not to redesignate section 410(b)(2) because of the number of forms and other publications which currently make reference to this provision.)

Section 7 would expand the class of distributions from qualified plans which may be "rolled over" into an individual retirement account or annuity.

Section 9 would change the rules applicable to "cafeteria plans" so that a cash or deferred profit sharing or stock bonus plan, as described in section 401(k), could be included in a cafeteria plan.

SUMMARY OF DEPARTMENTAL POSITIONS

1. H.R. 4498 and H.R. 5798 would provide tax credit for certain reforestation expenses. The Treasury opposes these bills.

2. H.R. 5719 would extend the tax exemption for proceeds of bingo games conducted by exempt organizations to situations where a local law prohibiting bingo is not generally enforced. The Treasury opposes H.R. 5719.

3. H.R. 6935 would allow refunds of taxes on certain state police officers' subsistance allowances. The Treasury does not oppose the principle of this legislation but believes that it should be amended to provide relief only for taxable years that were open as of October 7, 1978.

4. H.R. 7263 would provide special rules for expenses relating to deferred compensation plans for nonresident aliens. The bill also provides rules relating to foreign grantor trusts and the computation of earnings and profits with respect to such plans. The Treasury supports the deduction and foreign trust rules, but does not support the provisions regarding computation of earnings and profits.

5. H.R. 7276 would allow the investment credit for rehabilitated buildings leased to tax exempt organizations or governmental units. The Treasury opposes H.R. 7276.

6. H.R. 7318 would allow charitable deductions for certain contributions of partial interests in real property for conservation purposes. The Treasury believes this bill is objectionable in its current form.

7. H.R. 7392 would clarify limits on the deductibility of certain entertainment facility expenses includible in the income of the recipient. Although the Treasury would prefer a broader approach to certain information reporting requirements, the Treasury does not oppose H.R. 7392.

8. H.R. 7487 would impose an excise tax on lighter gauge steel drums. The Treasury opposes H.R. 7487 in its current form.

9. H.R. 7520 would alter the tax treatment of mutual or cooperative telephone and electric companies. The Treasury does not oppose exempting mutual or cooperative telephone companies from tax on pole rental income but has reservations about other aspects of the bill.

10. H.R. 7606: Employee Stock Ownership Improvements Act of 1980. The Treasury is opposed only to that provision of H.R. 7606 that would repeal the voting rights pass through required in certain defined contribution plans.

[Excerpt from statement of Hon. Daniel I. Halperin, Deputy Assistant Secretary (Tax Policy), Nov. 9, 1979]

H.R. 4611—CHARITABLE DEDUCTION FOR CERTAIN CONTRIBUTIONS OF REAL PROPERTY FOR CONSERVATION PURPOSES

H.R. 4611 would create an additional exception to the general rule prohibiting a charitable deduction for a contribution of a partial interest in real property and would also make two existing temporary exceptions, enacted in 1976 and scheduled to expire in 1981, permanent. As a matter of tax policy, the Treasury Department does not necessarily oppose this bill. However, we are concerned about the difficulty of measuring properly the value of the charitable contribution and with the potential for abuse of these exceptions.

We, therefore, believe it would be preferable to defer consideration of the bill until we have had further experience with the 1976 provisions. The very purpose of enacting legislation with a sunset date is to permit the Congress, the Administration and other interested parties to give careful consideration to these temporary provisions before deciding whether to let the legislation lapse, be extended or made permanent. In the meantime we would hope to see more information developed as to the type of transactions intended to be encouraged by H.R. 4611.

Under present law, in general, a charitable deduction is not allowed for income, estate or gift tax purposes for a contribution to charity (not in trust) of a partial interest in property. Two exceptions that permit deductions for partial interests in real property that are contributed exclusively for conservation purposes were added as part of the historic preservation and conservation tax incentives enacted with the Tax Reform Act of 1976. Under these exceptions, a taxpayer may donate, exclusively for conservation purposes, a lease, option to purchase, or easement with respect to real property that is granted in perpetuity, or a remainder interest in real property, and receive a charitable contribution deduction.[1] The term "conservation purposes" is broadly defined to include the preservation of land areas for public outdoor recreation or education, or for scenic enjoyment, the preservation of historically important land areas or structures, or the preservation of natural environmental systems. These two exceptions, as amended by the Tax Reduction and Simplification Act of 1977, contain the same sunset feature as the other historic preservation and conservation tax incentives enacted in 1976, all of which expire during the first half of 1981.

H.R. 4611 would amend present law in two respects. Section 1 of H.R. 4611 would augment the exceptions now in the Code by permitting a deduction for the contribution of any interest in real property, where the only interests retained by the taxpayer are oil, gas, or other mineral interests, and access thereto, provided that such retained oil, gas or other minerals may not be extracted or removed by means of strip mining, open pit mining, contour mining, area mining, or any other surface extraction method. This provision is not limited to contributions made exclusively for conservation purposes; it would apply to contributions made for any purpose. Section 2 would make permanent the present exceptions for contributions of partial interests in real property exclusively for conservation purposes.

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[1] We understand that it may be the opinion of the Solicitor of the Interior Department that section (4) of the Fish and Wildlife Improvements Act of 1978, as amended, 16 U.S.C. § 341f(b), authorizes deductions for contributions of partial interests in property to the Fisheries and Wildlife Service, regardless of whether such interests are eligible for a deduction under section 170(f)(3)(B) of the Code. If so, this opinion is incompatible with the Treasury Department's understanding of that legislation, and the Department of the Treasury does not consider itself bound by the opinion.

There are several reasons why the Internal Revenue Code denies a charitable deduction for the contribution of a partial interest in property. As early as the Revenue Act of 1964, Congress acted to deny deductions for future interests in tangible personal property as long as the intervening interest was owned by the taxpayer or a related person.[3] It was felt to be an abuse to allow a current charitable deduction for a gift of a painting, for example, which continued to hang in the taxpayer's home and would not be available for public use until after the taxpayer's death. In part, the difficulty in allowing a deduction for transfers of such interests is that, like other partial interests in property, they were regarded as difficult to value and therefore amenable to aggressive valuations that could not always be policed. Moreover, although the contribution of a remainder interest in property to a charity might well reduce the value of the property in private hands, it would not affect the donor's current enjoyment of the property in any material way. Thus, while the contribution of a future interest in property might properly be regarded as giving rise to a charitable deduction for estate tax purposes, when the donor's enjoyment of the property ceased, it was regarded as undesirable to give current recognition to the contribution of a remainder interest by allowing an income tax deduction as well.

In 1969, Congress focused on the difficulty of valuing the gift of a partial interest, particularly where the use of the property after the gift might be such as to favor the private interest over the charitable income interest. For example, if a charity were given an income interest in a trust, the trust assets could then be invested in growth stocks paying a low current return, leaving a greater remainder interest to accrue to the non-charitable remainder beneficiaries.[4]

The provisions that would be amended by H.R. 4611 raise several of these concerns. First, it may well be difficult to ascertain the diminution in market value of a parcel of property resulting from the transfer of less than the taxpayer's entire interest in the property for conservation purposes. It is therefore difficult to measure accurately the proper charitable contribution deduction. While valuation problems arise under other parts of section 170, the difficulties with valuing partial interests in real property may be particularly acute, especially where such interests have no impact on the donor's current enjoyment of the property.

Second, for a taxpayer who does not have the present intention to sell or develop the property, the gift of, for example, a conservation easement, while perhaps diminishing the value of the property, does not do so until a later date; in particular, it may have no material impact on the continuing enjoyment of the property by the donor of the easement. Allowing a current charitable deduction to such taxpayers thus appears inconsistent with the provisions barring deduction for gifts of future interests in art works. These problems seem especially likely to arise in the case of transfers of surface rights to property where only the mineral and related access rights are retained. Where the donor's principal interest is in the mineral rights, and where the ability to exploit those minerals is not affected by the gift, allowing a current deduction for a contribution of the surface rights has no greater adverse impact on the donor's enjoyment of the property than in the case of an individual who transfers a future interest in a painting to a museum, retaining the right to enjoyment of the painting throughout the donor's life.

There also may be instances in which one could question the charitable nature of such transfers. For example, the Treasury understands that statutes in some local jurisdictions provide taxpayers with a reduction in local property taxes in return for the grant of conservation easements; where that occurs it is not clear whether the contribution should be regarded as truly charitable. Not only is it somewhat troubling to grant a charitable deduction in such cases, but, in view of the private benefit from nondevelopment, the charitable deduction may not be essential to achieve the public purpose.

Finally, apart from questions such as these, it is not clear to us whether procedures exist to insure that a donated partial interest in property, such as a conservation easement contributed to a private charitable organization, will continue to be used for conservation purposes and for the benefit of the general public. Without mechanisms to insure the continued use of the donated interest for such purposes, it is not clear that the public interest is being properly served.

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[3] Now Section 170(a)(3) of the Code.

[4] Section 170(f)(2)(B). Section 17(f)(2)(B) is intended to preclude the double tax benefit of obtaining a charitable deduction for foregone income that is never reported on the taxpayer's return.

We recognize that the overriding benefits to the public may be sufficient to overcome these difficulties and to justify a charitable deduction in some circumstances. We are keeping an open mind on that issue. Nevertheless, in light of these concerns, it seems premature to consider H.R. 4611 at this point.

This is especially so in light of the fact that the rules were changed just three years ago. There has been insufficient time to gain experience with the new statute. It has taken charitable organizations time to become familiar with the new legislation and transactions involving these provisions have only recently begun to occur. It is only as transactions have begun to occur that we have started to become aware of possible abuse. For these reasons, we believe another year of experience with these provisions is needed before deciding whether they should become a permanent feature of the law, or if so, with what revisions.

For similar reasons, we also believe it would be premature to act on section (1) of H.R. 4611, which would permit a deduction for contributions of real property subject to retained mineral and related access rights. While it is argued in behalf of this provision that similar results can be obtained under existing law through the sale of subsurface mineral rights followed by the transfer of the taxpayer's remaining interest in the land, allowing a deduction for the contribution of surface rights by a donor who retains the mineral rights presents more difficult questions of valuation. Moreover, the transfers that would be authorized by section (1) are not, as is the case with other transfers of partial interests permitted by existing law, restricted to transfers for conservation purposes. Consequently, we feel the desirability of making such a revision to the existing provision should be considered in the context of an overall review of the provisions added with the Tax Reform Act of 1976.

Finally, we note that the provisions H.R. 4611 would make permanent were enacted as part of a package that included several provisions intended to encourage historic preservation. Those provisions, like the provisions with which H.R. 4611 is concerned, must also be reauthorized before June of 1981. In connection with the question of reauthorization both the Treasury Department and the Congressional Budget Office have initiated studies of the benefits, possible abuses and difficulties of administering these provisions. It seems to us a wiser course to permit studies of this entire area to be completed before acting on legislation such as this.

Mr. **Rostenkowski.** Thank you, Mr. Halperin.

Mr. Halperin, do you have this list of witnesses? The order in which I think we will approach questions on the various subjects is to go down this list and I will open it up to the subcommittee in that order.

With respect to H.R. 4498, do you think most timber incentives are focused in on by the big companies?

Mr. **Halperin.** Well, Mr. Chairman, I guess we would agree that the present benefits are tilted toward the larger companies and that because of the limitations on the amounts for which the credit can be granted that the present bill is an attempt to benefit the smaller producers. We do point out in our revenue estimate, however, that more than the half of the benefits would go to industrial production rather than the private production of timber so even this bill is still giving further benefits to the larger companies.

We also feel that if this approach suggests that we are spending our money in the wrong place and not directing it to those who may need it more, that we ought to consider cutting back on what we are presently doing at the same time that we are increasing subsidies in other cases. I don't think it is reasonable, given the larger tax benefits that now exist, to try to equalize the treatment among various segments of the industry by just bringing everybody else up. We should consider equalizing at a different point.

Mr. **Rostenkowski.** Do you think what we have done in government on incentives is a disincentive in reality to the timber industry? Were you here for Congressman Weaver's testimony?

Mr. Halperin. Yes, I was. He suggested there is a disincentive to plant trees because the cost of planting trees will not be recovered for a long period of time. In a sense, of course, the cost is recovered currently. We presumably would not plant trees unless we thought that the value will increase each year by a reasonable return on the property in the same way that people buy stock that does not pay dividends or buy land that they think will be developed later. Presumably if the investment makes sense, there will be an increase in value each year which in effect will provide a return to the investor and I think that just looking at the fact that there is no cash for a long period of time is not the correct way to look at it. If that were the case, we could give tax deductions to people who buy vacant land and people that buy stock in IBM. I don't think that is the proper way to look at it.

Mr. Rostenkowski. Mr. Duncan?

Mr. Duncan. I think what Mr. Weaver and Mr. Gudger implied was that use of land for other purposes will have a quicker return and provide a greater incentive than would planting trees. In other words either we need timber and we want to encourage its production or we don't.

Thank you, Mr. Chairman.

Mr. Rostenkowski. Any further questions? We will turn then to H.R. 7318, Mr. Jacobs' bill.

Mr. Halperin, several groups have recommended that the class of eligible donees for gifts of partial interests and real property should be expanded to include so-called 509(a)(3) organizations. Do you anticipate difficulties with such a modification?

Mr. Halperin. Mr. Chairman, we had felt that the potential donees ought to be limited to public charities in order to give us somewhat greater assurance that the easement will be enforced. We are concerned about gifts to those organizations without a substantial number of contributors and the feeling that there may be less reason for these organizations to enforce the easement and therefore the donor really has not given up very much.

509(a)(3) is a rather broad section. It was pretty much negotiated in the 1969 act in trying to deal with various problems that were presented where people did not want to be subject to the special private foundation rules. I think there are some organizations included within 509(a)(3) that would not trouble us if it were a subsidiary of a public charity, if it has the same board of directors as the public charity and is totally controlled by it that is OK. But, I think our feeling is that the courts have tended to be fairly liberal in applying section 509(a)(3) so we would be troubled by a complete extension to all 509(a)(3) organizations. I think it is possible to meet the concerns of those people who have written in without covering all 509(a)(3) organizations.

Mr. Rostenkowski. There have been suggestions which would require access to conservation easements, the donation of which has resulted in a charitable deduction. Is there a way that the public can receive a benefit from that donated easement without requiring public access?

Mr. Halperin. Mr. Chairman, there can be other ways in which the public can obtain a benefit and if there are other ways in which the public obtains a benefit then we do not feel that public access should be required.

Mr. ROSTENKOWSKI. What I am really trying to get at is the donation of an easement on property where the donor resides but still for all intents and purposes has the privilege and the tranquility of living there but with no public access.

Mr. HALPERIN. We are troubled with that. The donor has a tax deduction, he may or may not be worse off than he was before but the public has nothing more than it had before it started and we see no reason for a tax benefit to be provided in those circumstances. However, if you are talking about scenic enjoyment, the public may be able to have scenic enjoyment without going on the land.

Mr. ROSTENKOWSKI. From the roadside?

Mr. HALPERIN. Yes, from the roadside.

Second, if we are talking about the protection of the natural habitat of fish or wildlife, I think that there are public advantages to preserving habitats for fish and wildlife or for plants without the public having to be able to get on the land and in fact, of course, public access in some of those circumstances would interfere with the preservation of the natural habitat. So we think that there can be other reasons, other ways to establish public benefit other than public access but if these other reasons don't exist then public access should be required. If all we are talking about is preserving the land in a natural state because it is a nice thing to have land in a natural state, then it should be for the public and not just for the donor.

Mr. ROSTENKOWSKI. Mr. Halperin, under present law taxpayers have been permitted deductions for the contribution of certain open space easements. Would you view H.R. 7318 if enacted as superseding the interpretation of the current law?

Mr. HALPERIN. Mr. Chairman, I think that issue is under consideration in terms of the current regulations and rulings of the IRS. I think it certainly would be our feeling that it ought to supersede it. We are trying to determine a specific definition of what should be deductible, what types of conservation easements or gifts for conservation purposes should be allowed. I think that we could try to reach a comprehensive conclusion on that subject without leaving some vague area for the IRS to make an interpretation.

Mr. ROSTENKOWSKI. Mr. Halperin, reference has been made to migratory birds using the central flyway. Would you give me the parameters of central flyway?

Mr. HALPERIN. Well, I am not sure that I can precisely but I understand that it is felt that if a private party makes a determination not to build on a particular piece of the private party's own land and the argument is made that since the birds use that path for migration that therefore there is a public benefit if there is no development on that particular piece of land and therefore it is reasonable to provide a tax deduction.

We think that there are serious questions about that. It may well go too far and we certainly would wonder whether anybody who has received appropriated funds would expend those in order to obtain easements of this type. We think we certainly ought to be just as careful about spending tax funds.

Mr. Rostenkowski. Thank you.

Are there any further questions on H.R. 7318?

If not, we will move to H.R. 5719, Mr. Lederer's legislation on admitting the Internal Revenue Code.

Any questions, Mr. Lederer?

Mr. Lederer. I have no questions, Mr. Chairman.

Mr. Rostenkowski. Are there any questions on H.R. 5718?

If not, we will move then to H.R. 6935, Mr. Minish's police officers legislation.

Mr. Guarini?

Mr. Guarini. I understand that Treasury has no objection concerning this bill because you feel it is equitable, isn't that correct?

Mr. Halperin. Yes, Mr. Guarini. However, we have objected to opening the statute of limitation beyond the point that it would have been open at the time the original legislation was enacted.

Mr. Guarini. Now it is going to be possible for the State troopers in New Jersey to file a 140-X amended claim isn't that correct?

Mr. Halperin. Assuming that the statute of limitation for the years involved was open in 1978, they would be able to file a refund claim even though they previously have not asserted the right to exclude these amounts from income.

Mr. Guarini. But if they file form 872 for the year 1974, would that extend the statute of limitation to April 15, 1979?

Mr. Halperin. Generally, of course, the 1974 year would not have been open in October 1978 unless a waiver extension of the statute of limitation has been filed. Form 872 would be an appropriate vehicle in order to do that. I, of course, have not examined the specific document involved. I could not tell you whether it accomplished what would be needed in order to comply with this bill but the form 872 is an appropriate vehicle for extending the statute and if they had filed one to extend the statute for 1974 until April 15, 1979, then they would be able to take advantage of this legislation.

Mr. Guarini. The basic philosophy is to be evenhanded to those who overpaid in order to put them on the same basis as those who won their case and did not pay; isn't that correct?

Mr. Halperin. That is correct.

Mr. Guarini. Thank you.

Mr. Rostenkowski. Mr. Halperin, this is addressed to a problem in New Jersey. But is it just confined to those people or does it really include other taxpayers? I am sure that this would apply to other taxpayers who have been harmed the same way.

Mr. Halperin. Yes. The original bill was more confined to New Jersey and one or two other States because it provided benefits only to those police officers who asserted that the meal allowance was not taxable. This would give benefits to those that all along thought the meal taxes were taxable so we would have more widespread nationwide application.

Mr. Rostenkowski. Is there any formal way to notify the potential beneficiaries?

Mr. Halperin. No, we do not because it may be somewhat difficult to get the word out to them but I assume that their trade associations will let them know.

Mr. **Rostenkowski**. Any further questions on H.R. 6935?

If not, we will move to H.R. 7263, Mr. Conable's legislation. Are there any questions on H.R. 7263?

If not, we will move to H.R. 7276, the rehabilitation on tax exempt organizations for Government use. Are there any questions on H.R. 7276?

Mr. Stark?

Mr. **Stark**. What does it do?

Mr. **Rostenkowski**. It was explained earlier, Mr. Stark, but if Treasury would like to again explain it.

Mr. **Stark**. No. I will check with staff.

Mr. **Rostenkowski**. Mr. Gephardt's legislation, H.R. 7392.

Mr. Halperin, are you satisfied that this bill meets your overall policy objectives of strengthened information reporting on all sources of income?

Mr. **Halperin**. I think I can answer that two ways. One, we are satisfied that it meets the concerns that we had that the type of income involved would not be reported for income tax purposes unless the particular information return were filed. On the general question of whether or not we have a strong enough information reporting system, as we indicated in our written statement and as I stated orally we believe that substantial strengthening of that system would be desirable. One thing, there ought to be a requirement that the information return be provided to the taxpayer and not just to the Internal Revenue Service because we think those who get the form in the mail are more likely to report than those that do not.

Second, we think there ought to be significant penalties. We think that where the penalties are more significant compliance is much much greater than it is in this area where the penalties are very small and people may just choose to ignore it. We testified in the independent contractor legislation, for example, that there was widespread noncompliance with information reporting so we asked and we would renew our request here for more significant penalties on those who fail to comply.

Mr. **Rostenkowski**. On an overall basis, though, would you say that this bill would be an increased incentive to comply or a disincentive to comply? Do you think this legislation would increase or decrease tax compliance?

Mr. **Halperin**. Well, it is a difficult question. I suppose if we go back to the laws that existed after the 1978 act and denied the deduction to the provider of these benefits to the companies involved no matter whether or not the recipient reported the income, I suppose we collect more taxes but in some cases we would be collecting them from two sources, both from the provider and from the people who received the benefit. So I think it is reasonable to do what we can to give the provider the deduction and try to go as far as we can to insure that the recipient will report the income. We think that this bill gives us that reasonable assurance. Obviously you can always get more, but we think that this is a reasonable compromise result.

Mr. **Rostenkowski**. Thank you.

Any questions?

H.R. 7487, Mr. Guarini.

Mr. Guarini. Dan, I noticed you said that you would like a study done to see if there are other ways that this problem could be eliminated. Do you subscribe to the view that our tax laws can be used effectively to achieve a social objective?

Mr. Halperin. We certainly would agree that an excise tax is an appropriate way to internalize the cost. The present system does not necessarily impose on the user of these barrels the cost of disposing of them. What I think you are after in this legislation is to make those people pay for it rather than the general public and certainly one way of doing that would be to impose an excise tax on those who use it. Of course, if we are not going to end up with excessive costs, the excise costs should be generally related to the cost of disposal.

Mr. Guarini. The recycling of drums would in effect be cheaper for the consumer since costs are passed down to the consumer. The recycled drum costs considerably less per trip than a one-use drum. If you look into the economics of it, you would not only be able to preserve a vehicle for disposing of hazardous and toxic waste, you also pass along a savings to the consumer and increased sales of higher priced drums for the manufacturer. I can't say where there should be an objection to that kind of a result.

Mr. Halperin. Let me just raise two points on that. For one thing, this bill does impose costs on those who will continue to use light gage drums and have to use it for business reasons. They will not switch as I understand it, because of the need for parity of their products precludes taking a chance on using a reconditioned drum. Second, the cost of transportation may involve enough of a saving on the lightweight drum they would use it even though the lightweight one is more expensive than the heavy one.

We have done a study just last year, 1979, and the thing that I think that needs to be pointed out is that there are often significant costs for recycling. Transportation costs for getting the product back to the reconditioner and back out again to the user. Those transportation costs are energy costs to a large extent so it is not necessarily true that it is always better from the point of view of society to recycle as opposed to using new products.

What we should be trying to do is use the most efficient system. Now the most efficient system should, of course, take account of all costs, including those external costs which are not imposed on the users. So we think a system needs to be designed that operates in the most efficient way in which case the excise tax needs to be related to the cost imposed on the public for the cost of disposal of these drums.

Mr. Guarini. Do you know what the cost is to dispose of a drum found to contain toxic wastes after it has been improperly disposed of? Can I suggest to you that the answer we had in testimony was $600 and upwards.

Mr. Halperin. Per drum?

Mr. Guarini. Per drum. And this bill would be the cheapest and most effective way to prevent the problem and pass the savings down to the public. We have just completed a markup of the bill creating a super fund of $1.2 billion in order to handle the cleanup of dump sites. I can't see why we should drag our feet any longer. I think this kind of bill is essential. These drums have contributed to the hazardous waste problem and are going to be very expensive for our people.

Mr. **HALPERIN**. We understand the problem, Mr. Guarini. We would be willing to work toward a solution with you. The super fund legislation, of course, is another way of doing it and that is an attempt to equate the tax to the amount that is needed to clean up the cost since the two will adjust itself over the years.

Mr. **GUARINI**. I would also suggest to you that the economic route is a much cheaper route than establishing a large bureaucracy in order to control the manufacture of these kinds of drums. I think in a free economy that this would be the kind of route that would be most acceptable to industry and to all of us.

No further questions.

Mr. **ROSTENKOWSKI**. Any more questions?

Mr. Stark?

Mr. **STARK**. I do want to ask, is there any reason for this bill other than to preserve kind of a buggy whip type industry? Is it really just a question of putting an excise tax on a certain type of product which tends to, if used more widely, would put certain people out of work? That purely and simply is the result of this?

Mr. **HALPERIN**. I suppose that the main supporters of the bill are those who have reconditioned the drums or at least one source of support of the bill comes from that sector but I don't think that is Mr. Guarini's concern. He is looking toward the possibility of reducing pollution and litter by causing people to use these barrels more frequently and that certainly would be——

Mr. **GUARINI**. Would we not put an excise tax then on tin cans which could be replaced by bottles to keep the bottle washers going efficient than using steel cans? Is there any difference in that argument?

Mr. **HALPERIN**. I don't think so. Of course we approach the soda bottle problem by legislation which would require people to use returnable bottles.

Mr. **STARK**. Should we not put a tax on paper milk cartons? You are not old enough to remember this but when milk used to be delivered in bottles and your mother and/or dad washed them and the people at the dairy washed the bottles and we didn't waste all that timber that we waste now in paper milk cartons. So if we are going to follow this bill through our whole packaging industry, one could say that we should put some kind of a tax differential on paper beverage cartons. Would that also be true?

Mr. **HALPERIN**. I think it is also certainly true that there are all kinds of implications and all kinds of places once you start coming down this road.

Mr. **STARK**. Remember when the cottage cheese came in glasses and you washed and later drank your milk out of the glass. It would probably impoverish us all and certainly keep this committee in business for the next 10 years putting taxes on all kinds of recyclable containers.

Mr. **GUARINI**. Would the gentelman yield?

Mr. **STARK**. Glad to yield.

Mr. **GUARINI**. I hope that the gentleman from California does not equate vinyl chloride with cottage cheese. What we are really talking about here is disposing of hazardous waste and not recycling bottles or cardboard containers. We do have a recycling industry which is an essential link in disposing of these hazardous materials and it is not a question of unemployment because you would shift the numbers of people from perhaps one industry to another industry by strengthening the reconditioning industry which is most important in our disposing of these kinds of deleterious substances.

Mr. STARK. I have all these pallet manufacturers in my area who rebuild wood pallets. If we could eliminate plastic and metal and cut all that timber in Chairman Ullman's district—I think the bill is great but I have about 18 amendments to hang on it that are going to benefit East Oakland. I have no quarrel with it, I just wish I had thought of it first.

Mr. GUARINI. I am happy to have your support on curbing improper handling of detrimental substances in our society.

I have no further questions.

Mr. ROSTENKOWSKI. Are there any questions on H.R. 7520?

H.R. 7226?

If not, thank you very much, Mr. Halperin.

Mr. HALPERIN. Thank you, Mr. Chairman.

Mr. ROSTENKOWSKI. Mr. Dahl and Mr. White. If you would like to identify yourself and proceed with your testimony, gentlemen, the subcommittee is ready to accept it.

STATEMENT OF C. R. DAHL (CHAIRMAN AND CHIEF EXECUTIVE OFFICER, CROWN ZELLERBACH CORP.), ACCOMPANIED BY ZEBULON WHITE (PRESIDENT, ZEBULON WHITE CO.), ON BEHALF OF THE FOREST INDUSTRIES COMMITTEE ON TIMBER VALUATION AND TAXATION

Mr. DAHL. Mr. Chairman and members of the subcommittee, my name is Ray Dahl. I am the chairman and chief executive officer of Crown Zellerbach Corp., of San Francisco, Calif.

I am testifying today on behalf of the Forest Industries Committee on Timber Valuation and Taxation. This organization speaks on behalf of more than 5 million private forestland owners of all sizes and from all regions of the country.

I do have a brief summary that I would like to verbally present and at the end of this I would like to present a written statement which I have with me.

Mr. ROSTENKOWSKI. Your entire statement, as well as yours, Mr. White, will be included as part of the record.

Mr. DAHL. Thank you, Mr. Chairman.

H.R. 4498 proposes tax incentives to promote reforestation. While the Revenue Act of 1978 took a large step forward in improving reforestation when it partially restored capital gains benefits to their pre-1969 levels, further steps are necessary for timber supply to keep pace with projected demands. Specifically, there is a pressing need for recognition of the heavy front end cash requirements for soil preparation and planting. Under present law cost recovery on capitalized reforestation expenditures is delayed until the timber is sold or harvested which could be 30 to 70 years after initial investment. Partial recovery of these costs through the investment tax credit provided by H.R. 4498 would give timber owners treatment comparable to that of other owners of productive capital assets.

Seedlings take from 30 to 75 years to produce timber for lumber and plywood and 20 to 30 years to produce timber for pulpwood and with proper reinvestments in new plantings after harvest and careful management during growth, the timber resource can be renewed.

Congress long ago saw the need to clear a path for those with faith in the future and who could furnish the Nation's timber needs. In 1944, Congress recognized that incentives for the production of timber were inadequate and had resulted in a serious shortfall in reforestation with indications of severe timber shortages and extreme price escalation in the future. Therefore, in that year, Congress for the first time extended capital gains treatment to a full range of timber transactions. The reason for this was to stimulate timber management, which was seriously lagging. The result of the new tax policy was the most dramatic change in growth and planting in the history of American private forestry.

Charts contained in our written testimony show the impact in terms of U.S. timber growing stock and annual plantings in forests privately owned by industry and individuals. Prior to 1944 we grew 7 billion cubic feet less timber per year than we harvested. Since 1944, we have grown an average of more than 4 billion cubic feet more than we have harvested each year. We changed the substantial loss to a substantial net gain. In the case of planting, annual planting on private lands has increased from practically zero in 1944 to over 1 million acres per year.

Despite these increases in timber supply, we still face a substantial shortage in the near future. The U.S. Forest Service projects that domestic paper and wood product demand will double between 1980 and 2030. The question is how to satisfy this demand.

Public lands are the Nation's greatest source of standing timber but as they are under constant pressure for uses other than commercial timber production, harvest levels have become nearly static. Moreover, congressional appropriations have for years been insufficient for the level of forest management, including reforestation, that would increase production on U.S. forest service lands significantly, and we again urge greater congressional attention to this need.

Even with the increased public timber production, however, and with industry lands already producing at close to their full potential, the Nation still faces a critical timber shortage. It is therefore clear that the greatest potential improvement in timber supply rests with the private nonindustrial landowner. In the United States there are 283 million acres of nonindustrial timber land owned by 5 million plus private landowners. In general these lands are not intensively managed for timber production and produce wood at only about 60 percent of their potential.

My company's, as well as the industry's, interest in promoting expanded reforestation on the nonindustrial forest lands is simply the need for an expanded raw material base to meet our future demands. We, like most of our industry, who are highly integrated, are not self-sufficient in our timber supply. We purchase substantial volumes of wood fiber in varying forms to supply our pulp and paper mills and our other manufacturing facilities. If this industry is to meet the forecasted demand, we need to expand mill and plant capacity, but this expansion is not feasible without adequate raw material supply for such facilities.

The industry has made efforts to aid the nonindustrial landowner through reforestation assistance programs. While this has encouraged reforestation, it cannot provide adequate incentives to close the increasing gap between harvest and reforestation on these private nonindustrial timberlands.

H.R. 4498 would provide a 25-percent investment tax credit on the first $50,000 of capitalized reforestation expenditures each year and a 10-percent credit on amounts over $50,000. It would go far to encourage investments in planting and intensive management by private timberland owners.

While we fully support H.R. 4498, we would urge expansion and further improvement of the incentive it provides. Therefore, we recommend that H.R. 4498 be amended to include a 7-year amortization for capitalized reforestation expenditures. This is the approach taken in S. 100, Senator Packwood's reforestation proposal.

Other nations have moved far ahead of the United States in their recognition of the unique importance of timber as a renewable natural resource. In all free nations which have been studied there has been a universal acceptance of the concept that timber-producing property is a uniquely valuable capital asset and that tax incentives are essential to overcome the deterrent to investment, to modern forest management practices, and to higher productivity that is created by the long growth cycle and the consequently delayed recovery of the investment. It should be remembered that we are dealing with a special investment cycle which ranges from 20 to 75 years.

Every year we delay implementing adequate policies means a year of inadequate wood supplies in the future. We must take steps today to encourage sufficient investment in timber growing to meet tomorrow's needs.

We appreciate the efforts of Members of Congress who recognize the need for reforestation incentives and look forward to working with the Ways and Means Committee on the recommendations outlined in this testimony.

[The prepared statement follows:]

STATEMENT OF THE FOREST INDUSTRIES COMMITTEE ON TIMBER VALUATION AND TAXATION

SUMMARY

The Forest Industries Committee on Timber Valuation and Taxation speaks on behalf of approximately four million private forestland owners of all sizes and from all regions of the country. The principal public policy objective of the Committee is the attainment and preservation of equitable federal tax provisions to reflect the long-term nature of forest investments and the unique risks involved.

While the Revenue Act of 1978 took a large step forward in improving reforestation incentives when it partially restored capital gains benefits to their pre-1969 levels, further steps are necessary in order for timber supply to keep pace

with projected demand. Specifically, there is a pressing need for recognition of the heavy front-end cash requirements for site preparation and reforestation.

A number of proposals have been introduced in this Congress to recognize these costs earlier and thus give timber taxpayers equivalent treatment to that of other owners of productive capital assets.

The subject of these hearings, H.R. 4498, would provide a 25 percent investment tax credit on the first $50,000 of capitalized reforestation expenditures each year and a 10 percent credit on amounts over $50,000. It would have a significant favorable impact on the rate of return on investments by timberland owners—investments which are critically important to the nation's long-term timber supply.

While we fully support H.R. 4498, ultimately we would urge expansion and further improvement of the incentive it provides.

For the purposes of these hearings, however, we would suggest only two modifications.

First, we would support amending H.R. 4498 to include 7-year amortization for capitalized reforestation expenditures. This is the approach taken in S. 100, Senator Packwood's reforestation proposal, which has been approved by the Senate Finance Committee.

The combination of the investment tax credit plus 7-year amortization would equate the tax treatment of timber investments with the treatment provided for investments in machinery and equipment.

And, second, we would suggest certain definitional changes as indicated in our detailed statement.

• • • • • • •

We are appreciative of the efforts of Members of Congress who recognize the need for reforestation incentives and look forward to working with the Ways and Means Committee on the recommendations outlined in this testimony.

STATEMENT

This testimony is presented on behalf of the Forest Industries Committee on Timber Valuation and Taxation. Our Committee speaks on behalf of approximately 4 million forestland owners of all sizes and from all regions of the country. For the purposes of this testimony we also represent 61 forest-related associations, including the American Paper Institute, American Plywood Association, American Pulpwood Association, Forest Farmers Association, Industrial Forestry Association, National Forest Products Association, and the Southern Forest Products Association. A list of the 61 associations is attached to this testimony as Appendix No. 1.

The principal public policy objective of the Committee is the attainment and preservation of equitable federal tax provisions to reflect the long-term nature of forest investments and the unique risks involved.

Part I of our testimony reviews the importance of an adequate timber supply to our national economy, the potential for increased forest productivity, and the reasons why timberland owners often find forestry investments to be economically unattractive.

Part II discusses why private, nonindustrial landowners are key to increases in timber productivity. Part III analyze the impact of tax policy on forest productivity, showing in particular the favorable effects on reforestation of timber capital gains.

Finally, Part IV reviews and makes recommendations concerning H.R. 4498.

I. Ensuring Timber Supply: A National Goal

We start with the basic premise that ensuring an adequate timber supply is a vital national goal. However, the nation's timber needs will not be met if timberland owners do not have sufficient economic incentives to invest in forestry.

A. Timber supply and demand

The Forest Service projects that domestic paper and wood product demand will double between 1980 and 2030. Demand for paper and wood products is expected to reach 28.3 billion cubic feet in the year 2030, up from 13.3 billion cubic feet in 1976. Table I summarizes the projected supply/demand situation.

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TABLE I.—SUMMARY OF U.S. SUPPLY AND DEMAND FOR SOFTWOODS AND HARDWOODS IN 1976 AND FOR 2030—BASE LEVEL PROJECTION[1]

[In billion cubic feet]

Category	1976	2030
Softwoods:		
Total U.S. demand	10.3	18.7
Exports	1.3	.9
Imports	2.4	3.9
Demand on U.S. forests	9.2	15.7
Supply from U.S. forests	9.2	12.3
Supply/demand balance	0.	−3.4
Hardwoods:		
Total U.S. demand	3.0	9.6
Exports	.2	.4
Imports	.3	.6
Demand on U.S. forests	2.9	9.4
Supply from U.S. forests	2.9	8.9
Supply/demand balance	0.	−.5
All timber:		
Total U.S. demand	13.3	28.3
Exports	1.5	1.3
Imports	2.7	4.5
Demand on U.S. forests	12.1	25.1
Supply from U.S. forests	12.1	21.2
Supply/demand balance	0.	−3.9

[1] Assumes price rises similar to those experienced from late 1950's to mid-1970's.

Source: USDA—Forest Service, January 1980, "An Assessment of the Forest and Range Land Situation in the United States."

One of the principal reasons why insufficient timber supplies are projected for the future is because there are currently inadequate levels of reforestation on some of our nation's public and private forestlands.

The following section shows the extent to which the potential for increased productivity in this country is not being met.

B. The potential for increased forest productivity

In May, 1980, the Forest Industries Council released its "Forest Productivity Report," which analyzes and makes recommendations for the improvement of forest productivity in the United States on a state-by-state basis. The study encompassed 25 states which contain 404.4 million acres of commercial forestland, 83 percent of the U.S. total.

1. *Current levels of management.*—The Forest Productivity Report found that in the study states for which data was available, approximately 5 million acres were being harvested annually using various cutting methods. At the same time only 2.2 million acres were being purposefully regenerated, as shown on Table II.

TABLE II.—ESTIMATED ANNUAL AVERAGE LEVELS OF FOREST MANAGEMENT IN THE 25 STUDY STATES BY OWNERSHIP, 1976–78[1]

[Thousand acres]

Ownership	Planting or seeding	Site preparation for natural regeneration	Intermediate stand management	Harvest
National Forest	262.2	50.6	282.3	678.5
Other public	106.4	28.8	116.2	188.9
Forest industry	1,221.7	197.7	399.9	1,503.9
Other private	265.1	49.2	118.0	2,784.9
Total	1,855.4	326.3	916.4	5,156.2

[1] Lake State and border State regions excluded from table due to lack of adequate data.

The major gap between harvest and regeneration was for the private, nonindustrial ownership, where approximately 1 in 9 harvested acres were being purposefully regenerated.

It should be noted, however, that in some areas and under certain conditions natural regeneration is a sound forest management practice. Nonetheless, it is still safe to conclude that regeneration on private, nonindustrial lands is not adequate to effectively replace the harvested stands. In addition, the report found that millions of additional acres exist which are presently nonstocked, inadequately stocked, or are softwood sites which are occupied with low quality hardwood species.

2. *Investment opportunities.*—The Forest Productivity Report found that there are a total of 139.2 million acres in the 25 study states which would provide investment opportunities with a 10 percent or better after-tax return. These opportunities for increased forest productivity would require an initial investment of $10.3 billion, which would increase annual growth by 10.9 billion cubic feet or 50 percent over current levels.

Approximately 72 percent of the investment opportunities (100 million acres) requires regeneration treatments.

C. Difficulty of attracting capital

Despite these opportunities for increased forest productvity, forestland owners often find that the arguments against forestry investments are overwhelming. You hear these kinds of comments:

1. I'll die before the trees are old enough to cut.
2. There is too much risk of fire, disease, and storms. Casualty loss insurance is simply not economically available on standing timber.
3. The initial capital investment costs (land preparation, roads, plantings) and annual maintenance costs are higher than ever before.
4. There is no annual income, like rents or dividends.
5. I'm scared that Uncle Sam will take whatever profits I make away from me with confiscatory taxes.

These are the handicaps which must be addressed by the Congress if we are to anticipate and prepare for the timber supply needs of the United States by the year 2030 and beyond. We cannot wait until the shortage is upon us to take remedial action. We will never find a way to grow a tree in that short a time.

D. Benefit to society of forestry investments

1. *Importance of timber growing to national economy.*—The forest products industry is the nation's seventh largest in terms of value of product shipments. It is comprised of more than 35,000 companies with 40,000 production facilities providing employment for about 1.2 million workers. The value of shipments by these companies totaled $79.5 billion in 1976, about 6.7 percent of all U.S. manufacturing.

The Forest Service estimates that all economic sectors associated with wood and paper products provided employment for 27.5 million people and added over $324 billion in product values to the economy in 1972 (Table III).

TABLE III.—ESTIMATED VALUE ADDED AND EMPLOYMENT BY TOTAL AND THAT ATTRIBUTABLE TO TIMBER IN TIMBER-BASED ECONOMIC ACTIVITIES, 1972

Economic activity	Value added (billion dollars) Total	Value added (billion dollars) Attributed to timber	Employment (million people) Total	Employment (million people) Attributed to timber
Timber management	2.9	2.9	0.1	0.1
Harvesting	3.1	3.1	.2	.2
Primary manufacturing	10.1	8.8	.5	.4
Secondary manufacturing	34.0	12.5	2.7	.9
Construction	79.6	11.9	5.3	.8
Transportation and marketing	194.2	9.3	18.7	.8
Total	323.9	48.5	27.5	3.2

Source: USDA—Forest Service, unpublished.

For every job and dollar invested in growing timber, an additional 28 jobs and $17 were generated before the product was finally consumed.

Thus, an incentive to help private timberland owners manage their lands rather than neglecting them will benefit the entire nation. The "ripple" through other industries will create wealth and add to the national tax base.

2. *Environmental considerations.*—Unlike other basic resources, forests are renewable. Timber, a storehouse of solar energy, is most compatible with man's use in his present environment because of its strength, its versatility, its ease of production, and its biodegradability.

In addition to the quality of renewability, wood has significant environmental advantages over other materials in the processing stage. Timber products are produced and processed with much lower energy requirements and with relatively little adverse environmental effect. Processing steel for construction, for instance, takes four times the energy of processing lumber for the same purpose. For aluminum, it takes 20 times the energy.

Production of wood substitutes also creates more air, water and solid waste pollution than does the production of wood. Much of wood fiber can be recycled. What is not is biodegradable and returns to the earth. Charts I and II compare the low energy and pollution cost of processing solid wood products compared with other substitutes.

CHART I

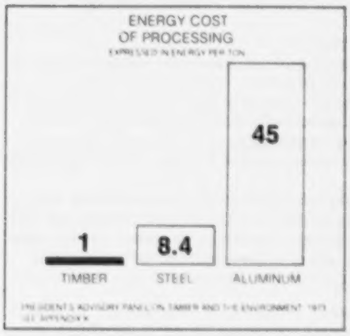
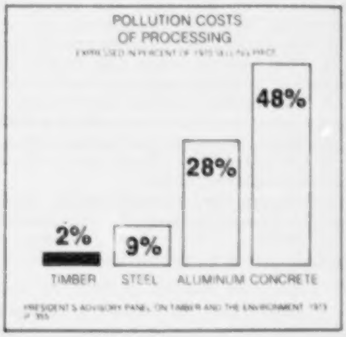


CHART II



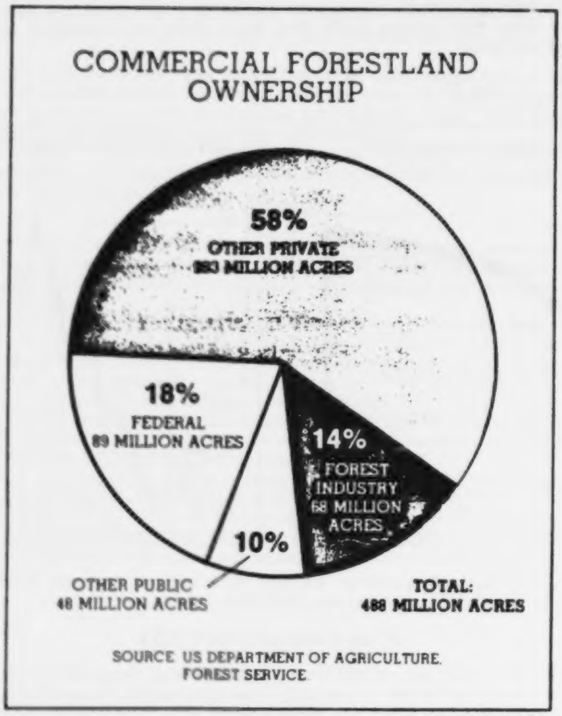
Moreover, timberlands help provide a home for our wildlife, support livestock herds, provide recreational opportunities, and are an important element in the conversion of carbon dioxide to oxygen.

3. *Impact on inflation.*—If our tax policies create a reduction in timber production, severe shortages may result. Such shortages can exert pressure on the price of wood building materials and housing, with the effects being felt throughout the entire economy.

II. Increase in Timber Supply Must Come From Private Nonindustrial Landowners

Chart III shows the distribution of forestland ownership in this country. Of the categories shown, the greatest potential for increased production comes from the 283 million acres owned by 4 million private landowners. In general, these lands are not intensively managed for timber production and produce wood at only about 63 percent of their potential.

CHART III



SOURCE US DEPARTMENT OF AGRICULTURE.
FOREST SERVICE.

In contrast, public lands are under constant pressure for uses other than commercial forestland, harvest levels are nearly static and funds perennially have not been provided for adequate forest management. The industry lands comprise only 14 percent of the total and are producing at close to their full potential. It is therefore clear that the largest area of potential improvement comes from the private, nonindustrial landowner.

The U.S. Forest Service's "1980 Report to Congress on the Nation's Renewable Resources" addresses the situation as follows:

"The most critical demand on the Nation's timber will be for softwood sawtimber while public lands will continue to play a major role during the decade of the 80's. The best opportunities to increase softwood supplies are on private non-industrial forest land. The leveling off of harvests from industrial land accentuates the importance of nonindustrial private land. It is here that much of the increased demand for softwood would be met through increased harvest and reforestation."

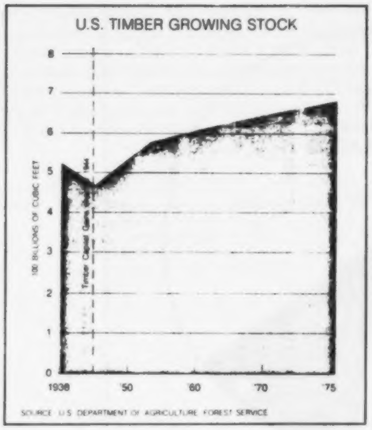
III. Tax Policy: An Effective Incentive

The history of capital gains treatment of timber income shows that tax policy can be effective in stimulating increased planting in private forests.

In 1944, Congress extended capital gains treatment to the full range of qualified timber transactions rather than only to lump sum, liquidation-type sales. What followed was the most dramatic change in growth and planting in the history of American private forestry.

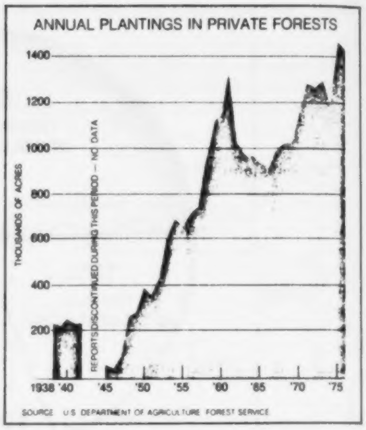
Charts IV and V show the impact in terms of U.S. timber growing stock and annual plantings in private forests. Prior to 1944, seven billion cubic feet more timber was harvested than was grown annually. Since 1944, we have grown an average of over four billion cubic feet more than we harvested each year, a substantial net gain.

Chart IV



SOURCE: U.S. DEPARTMENT OF AGRICULTURE, FOREST SERVICE

Chart V



SOURCE: U.S. DEPARTMENT OF AGRICULTURE, FOREST SERVICE

And, in the case of planting, annual plantings on private lands have increased from practically zero to over one million acres per year.

IV. An Analysis of H.R. 4498

While the Revenue Act of 1978 took a large step forward in improving reforestation incentives when it partially restored capital gains benefits to their pre–1969 levels, further steps are necessary in order for timber supply to keep pace with projected demand. Specifically, there is a pressing need for recognition of the heavy front-end cash requirements for site preparation and planting.

The subject of these hearings, H.R. 4498, would provide a 25 percent investment tax credit on the first $50,000 of capitalized reforestation expenditures each year and a 10 percent credit on amounts over $50,000. It would have a significant favorable impact on the rate of return on investments by timberland owners—investments which are critically important to the rate of return on the nation's long-term timber supply.

While we fully support H.R. 4498, ultimately we would urge expansion and further improvement of the incentive it provides.

For purposes of these hearings, however, we would suggest only two modifications.

First, we would support amending H.R. 4498 to include 7-year amortization for capitalized reforestation expenditures. This is the approach taken in S. 100, Senator Packwood's reforestation proposal, which has been approved by the Senate Finance Committee.

The combination of the investment tax credit plus 7-year amortization would equate the tax treatment of timber investments with the treatment provided for investments in machinery and equipment. For example, in the case of productive equipment, both rapid capital cost recovery and the investment tax credit are generally available.

And, second, we are concerned that the definition of "qualified forestry expenditures" in H.R. 4498 may be so broad that it would create opportunities for abuse. The current version of the H.R. 4498 reads as follows:

"The term 'qualified forestry expenditures' means any amount chargeable to capital account and paid or incurred for (A) the generation or regeneration of a timber stand for purposes of forest growth and quality, fish and wildlife habitat, soil stabilization, and outdoor recreation * * *"

We assume that the principal motivation behind H.R. 4498 is to stimulate timberland owners to make reforestation expenditures in qualified timber property, i.e., property which is held by the taxpayer for the planting, cultivating, and cutting of trees for sale or use in the commercial production of timber products.

In contrast with this presumed objective, H.R. 4498 would have a far broader application. It would in all likelihood include trees for many purposes other than timber production, such as hunting and fishing clubs, wind breaks, camp grounds (public and private), and other such purposes.

We would prefer to see H.R. 4498 amended to include the definition of qualified expenditures in S. 100, which, with a minor modification, is attached to this testimony as Appendix No. 2.

V. Conclusion

All tree planters, from the small tree farmer to major corporations, have one thing in common—a very uncommon faith in the future. To spread that faith, we must take steps to encourage sufficient investment in timber growing to meet tomorrow's needs.

Other nations have moved far ahead of the United States in their recognition of the unique importance of timber resources in this era of resource decline. In such countries as Great Britain, Norway, Sweden, Holland, West Germany, France, Finland, Switzerland, Brazil, Australia, New Zealand and Japan (in fact, in all free nations which have been studied), there has been a universal acceptance of the concept that timber producing property is a uniquely valuable capital asset and that tax incentives are essential to overcome the inherent handicaps to investment and higher productivity.

Every year we delay the implementing more adequate policies, means of year of delay in providing adequate future wood supplies.

We are appreciative of the efforts of Members of Congress who recognize the need for reforestation incentives and look forward to working with the Ways and Means Committee on the recommendations outlined in this testimony.

APPENDIX 1

COOPERATING ASSOCIATIONS

NATIONAL ASSOCIATIONS

American Institute of Timber Construction.
American Paper Institute.
American Plywood Association.
American Pulpwood Association.
American Wood Preservers Association.
American Wood Preservers Institute.
Associated Cooperage Industries of America, Inc.
Fine Hardwoods-American Walnut Association.
Hardwood Dimension Manufacturers Association.
Hardwood Plywood Manufacturers Association.
National Christmas Tree Growers Association.
National Forest Products Association.
National Hardwood Lumber Association.
National Oak Flooring Manufacturers Association.
National Particleboard Association.

REGIONAL ASSOCIATIONS

Appalachian Hardwood Manufacturers, Inc.
Forest Farmers Association.
Industrial Forestry Association.
Northeastern Lumber Manufacturers Associations, Inc.
Northern Hardwood and Pine Manufacturers Association, Inc.
Pacific Logging Congress.
Southeastern Lumber Manufacturers Association.
Southern Forest Products Association.
Southern Hardwood Lumber Manufacturers Association.
Southwest Pine Association.
Western Forest Industries Association.

Western Forestry and Conservation Association.
Western Timber Association.
Western Wood Preservers Institute.
Western Wood Products Association.

STATE ASSOCIATIONS

Alabama Forestry Association.
Alaska Loggers Association, Inc.
Arkansas Forestry Association.
Associated Oregon Industries.
California Forest Protective Association.
Eastern North Carolina Lumber Manufacturers Association, Inc.
Florida Forestry Association.
Georgia Forestry Association, Inc.
Kentucky Forest Industrial Association.
Louisiana Forestry Association.
Lumber Manufacturers' Association of Virginia.
Maine Forest Products Council.
Maine Hardwood Association.
Minnesota Timber Producers Association.
Mississippi Forestry Association.
Misouri Forest Products Association.
New Hampshire Timberland Owners' Association.
New York Forest Owners Association.
North Carolina Forestry Association.
Oklahoma Forestry Association.
Oregon Forest Protection Association.
Society for the Protection of New Hampshire Forests.
South Carolina Forestry Association.
Southern Oregon Timber Industries Association.
Tennessee Forestry Association.
Texas Forestry Association.
Timber Producers Association Inc. of Michigan and Wisconsin.
Virginia Forestry Association.
Washington Forest Protection Association.

PROFESSIONAL AND PUBLIC ASSOCIATIONS

Association of Consulting Foresters.

APPENDIX 2

SUGGESTED DEFINITION OF QUALIFYING REFORESTATION EXPENDITURES

"The term 'reforestation expenditures' means direct costs incurred in connection with forestation or reforestation by planting or artificial or natural seeding, including costs—

"(i) for the preparation of the site;

"(ii) of seeds or seedlings;

"(iii) for labor and tools, including depreciation of equipment such as tractors, trucks, tree planters, and similar machines used in planting or seeding."

Mr. ROSTENKOWSKI. Thank you, Mr. Dahl. Mr. White?

Mr. WHITE. Thank you, Mr. Chairman.

I am Zebulon White and have been adviser to Southern landowners in forest industries for 40 years, including 15 years as a professor at Yale School of Forestry. I wish to speak briefly in favor of H.R. 4498. As professionals our ultimate goal in management is intensive forestry, preferably plantation forestry from which we can get the optimum yields per acre. The majority of existing forest plantations were established on abandoned farms or abandoned pastures and on cutover forest land that had been kept bare by repeated fires. Plantation forestry has been successful and profitable in the past when the major cost was the planting of seedlings. Plantation forestry is not an attractive investment today because those favorable open sites are no longer available and it usually requires intensive preparation of wild and brushy ground to receive the favored seedlings. The cost of this site preparation is rapidly pricing tree planting out of the reach of private landowners and the forest industry is concerned by the narrowing gap between costs and returns.

In 1978 in the five States surrounding my home, Alabama, Mississippi, Arkansas, Louisiana, and Texas, other private landowners carried out some type of harvest on over 1 million acres but they only spent regeneration capital on 120,000 acres, about 11 percent of the harvested acreage. We use the rule of thumb that only 1 out of 9 acres harvested by private owners has any regeneration money spent on it.

The experience of one of my clients will illustrate why landowners tend to rank regeneration investments with the very low priority. In 1977 we cut the clients' timber. We prepared the cutover area and planted 150 acres with genetically superior pine seedlings. The total cost was $15,000 or $100 per acre. A footnote here, this cost would be more than $150 per acre today.

The first summer of the plantation a long drought nearly killed the whole plantation but it pulled through with the survival rate which will probably mean a lower yield. Beginning the first summer the Nantucket pine type moth killed and stunted growth again reducing the eventual yield. Although fire protection there is excellent there is always the possibility of total destruction of his plantation by fire. The capital investment in the plantation was made with after-tax dollars. There will be no income and none of the capital can be recovered as a cost until the planted trees become merchantable in this plantation at least 15 to 20 years after the investment and no imputed interest can be added.

In 15 years the capital investment is transferred out of this limbo account into the timber account where it is gradually recovered as a cost over the entire life of the forest on a unit depletion basis. Additionally, if we find that we must eradicate the hardwood competition around these pine trees, that expense must be capitalized; without including land value investments in forest plantations in the South which usually will not earn more than 6 percent at current levels of cost and income.

The addition of current forest land prices to the capital investment pushes the return on total investment down toward zero or even below. In contrast, when we invested my client's $15,000 in the plantation in 1977, moneymarket funds were paying 10 percent. So as a consultant I cannot advise landowners that a new forest plantation is a prudent investment. In 1978 I asked an assembled group of forest economists how many of them personally would invest an unexpected windfall of $100,000 in timberland or forest plantations. Out of 75 experts present, 3 raised their hands.

If we are to continue to have even a portion of our harvested acreage maintained in intensive forestry, we must somehow make the initial plantation investments more comparable to other investments and attractive at least to those who already own the land. An investment tax credit or part of the plantation cost as proposed in Mr. Weaver's bill would encourage thousands of landowners to give more serious consideration to intensive forestry on their timberlands.

Countries around the world discovered long ago that optimum fores production is a national goal and have been negotiating judicious tax relief supplemented by cost or grant sharings. England and Japan have specific laws designed to give private owners incentives to plant forests and to keep them productive. Norway, for example, exempts forest plantations from taxes for 30 years. In Australia, forest operations are classified as "primarily production" and as such qualify for special income tax provisions. Most forest expenditures, including planting, are deductible annually against income.

Brazil provides an outstanding example of the results of a significant tax incentive. Beginning in 1967 a law providing for a generous investment tax credit for reforestation encouraged the planting of 4.5 million new trees in 8 years. This one act has made Brazil a contender in the future pulp and paper markets of the world.

In this regard, Mr. Chairman, I would like to offer for the record a description of this Brazilian development prepared by Mr. M. H. Collet.

Mr. ROSTENKOWSKI. Without objection, it will be made a part of record.

[The document to follow:]

BRASILIAN TAX REFORESTATION PROGRAM

M. H. Collet *

Prior to the year 1966, a few companies in Brasil had regular reforestation programs. Among these companies, a number of American paper companies had established rather extensive forest plantations. These included Olinkraft and Westvaco, with forests of U.S. Southern Pines, predominantly Loblolly and slash pine, and Champion with plantations of Eucalyptus.

In 1965, after many years of inertia, the federal government of Brasil announced a new forest code (Law No. 4771) and during 1966 a new reforestation law (Law No. 5106) aimed at building a man-made forest base to support future Brasilian forest products industries. Prior to the 1964 revolution, government efforts at encouraging reforestation under the Instituto Nacional do Pinho (National Pine Institute) had been very unsuccessful due both to the attempt to plant the native species Parana pine (*Araucaria angustifolia*) and the lack of incentives for the principal users of this species, namely the lumber companies, to plant a difficult and slow growing tree.

Early efforts by railroads in Brasil to introduce Eucalyptus plantations had been extremely effective, and from the 1920's through the 1950's Eucalyptus plantations had formed the principal raw material for railroad firewood, as well as charcoal for the metallurgical industry from Bahia to Rio Grande do Sul, but mainly in the States of Minas Gerais, Rio de Janeiro and Sao Paulo.

The 1965 forest code, requiring compulsory replanting at the rate of 10 trees for every cord of timber cut, and the 1966 reforestation law which provided for the necessary funds through an incentive of 50% on income tax obligations — when applied on previously approved forestry projects planted on privately owned lands — resulted in a major expansion of both Eucalyptus and Coniferous plantations in Brasil, as well as other forestry and fruit species.

The first projects set up under this tax incentive program were made during the year of 1967, and Olinkraft was the first company to take advantage of the mentioned incentives during that year in the State of Santa Catarina, where it operates a kraft pulp and paper mill.

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* President, Olinkraft, Inc.

Under the original 1966 version of the law, a taxpayer, whether individual or company, could use up to 50% of his federal income tax obligations to finance the clearing of land, planting, cleaning the young plantations, protecting plantations from fire, insects and diseases, essential road, bridge and culverts and fire lane construction and maintenance as well as nursery cost and all administration, supervision and their transportation costs. Although the reforestation program over the ensuing 9 years has undergone many changes, including a reduction in the south of Brasil from the original 50% to 22.5% of the tax deduction, the principal elements of the program work as follows:

1. A fully registered forestry company, assume Lages, Ltda., an Olinkraft subsidiary, submits a proposed reforestation project of say 250 acres to the State Office of the Instituto Brasileiro de Desenvolvimento Florestal (IBDF) showing:

   a. Land title to prove ownership or legal lease.

   b. Topographical map of the considered area showing its natural vegetation, roads and fire lanes to be built, as well as the areas of natural forests to be preserved along rivers, streams and where slope of terrain is more than 45°. Contour lines with 5 meter intervals are also required.

   c. The projected costs for the first 4 years of the project when the fiscal incentives can be applied.

      c.1. Land clearing

      c.2. Planting

      c.3. Disease and insect control

      c.4. Plantation cleanings

      c.5. Road, bridge, culverts and fire lane construction and maintenance

      c.6. Management

      c.7. Replanting

   d. Justification for the implantation of the forest and the use of the wood to be produced.

The IBDF forester and field examiner then considers the project on the ground and if no conflicts exist with previously determined government standards, he gives the forestry company a preliminary approval to proceed with the submitted project.

2. In due course, up to 3 months, the IBDF State headquarters advises whether they grant project approval to the project or whether modifications must be made to obtain approval. If no modifications are requested and 3 months have elapsed from date of submission,

the project will be automatically approved. With the elapse of time more and more silvicultural measures have crept into the IBDF decisions involving the first 4 years of the plantations program. It is during the first 4 years of the reforestation project that the fiscal incentives can be applied. During the additional minimum 16 years involved, all costs then incurred must be carried by the owner or owners of the trees planted. Currently, IBDF payments for reforestation projects are being delayed over six months due to Brasil's serious foreign exchange deficit and the government policy of deferring all payments and monetary transactions.

3. If the contributor of the income tax has sufficient income tax obligations, he can decide to apply the present 22.5% of its income tax to pay to a reforestation project. The forestry company receives the options from the different corporations or individuals according to the IBDF approved projects — thus fulfilling their financial requirements for these projects.

If the forestry company has not sufficient "investors" then the IBDF will make enough funds available from unknown investors, through a Bank of Brasil special fund, formed from options of those companies which did not pick their own forestry projects.

4. If the income tax incentive of other investors is used in addition to the company's own incentives to finance the approved forestry project, then the registered reforestation company must identify the outside investor or group of investors and sign a formal reforestation contract with them, and also lease or sub-lease to them the land where the forest will be established. This lease must comply with the foreseen minimum length of the project, i.e., 20 years.

5. The reforestation contract in the case of Olinkraft's projects calls for a reimbursement to the taxpayer of his original investment 7 years after the date of signature of the contract. The reimbursement takes the form of his initial tax contribution plus the monetary correction of the cruzeiro currency during the 7 years of elapsed time. Monetary correction is the inflationary amount reflected in the adjustment of Brasilian treasury bonds. In most of our contracts with the outside investors the monetary correction is limited to a ceiling of 14% per annum simple interest. The reforestation company owns the trees during the full rotation of the established plantation, but these trees serve during the first 7 years as security to the investor for his tax investment. Should anything happen to the trees during this period of time, i.e., fire, insect damage, wind damage, ice or frost damage, flood, etc., the reforesting company still remains responsible to the investors for the contracted reimbursement of his tax funds plus monetary correction. In summary, the investors will recover their investment plus monetary correction independent of

the success or failure of the established forest. It is the Olinkraf forester's job to assure the success of the forest.

6. The IBDF follows up on the approved reforestation project with at least an annual fiscalization on the ground to determine if th project commitments have been fulfilled. Any deficiencies in a project such as seedling survival and cleaning or road and fire lan maintenance must be corrected at the expense of the plantation company and any IBDF authorizations for payments due will not b granted until such deficiencies are corrected.

7. At such time that cutting can be started, which happens a early as 6 years for Eucalyptus and 8 years for U.S. Southern Pines, cutting plan must be submitted to the IBDF for approval, showin the use for the wood, thinning methods in the case of the U.S Southern Pines, volume of timber harvested and its commercia value. The IBDF forester will either approve the plan or, after seein the plantation, request some modification according to his view o the technical needs of the plantation. The plan, after approval, i valid for about one year. When completed, additional informatio must be given to the IBDF, which also has the right to do groun fiscalization.

It must be understood that while the forest belongs to the investors or to the reforestation company, the IBDF will have a right, during the length of the project (20 years), to fiscalize and to see tha the forest, grown with public monies, will fulfill the needs of th country. Of course when the project is originally submitted for approval, the timber to be grown must have a determined use. This ca change, however, as trees grow in diameter and height and becom suitable for products other than pulp. But it must be recognized tha if an additional market develops, such as plywood for example, th trees originally planted for pulpwood may be directed into plywoo with only residual fiber going to the pulp mill.

Presently there is a strong tendency to review the fiscal incentives law, making sure that for some determined length of time a fixed percentage rate of the income tax can be used for new forests Therefore, the Federal Government is considering a plan to instal 30 Forestry Districts of man-made forests. Initially there will be 1 such districts, located in areas where forestry operations are already established or potentially possible. These areas must still be selecte but it is already known that some States, like Santa Catarina, Parana Sao Paulo and Minas Gerais, will be included in the plan. In thes Forestry Districts, there are already existing or planned pulp an paper mills. This program of Forestry Districts will not be made by unilateral decision of the IBDF, but such Councils, like the C.D.I (Council for Development of Industries) and C.D.E. (Council fo

Economic Development) will have a strong say in the decision. Such reasoning is thought justified, since many forestry projects have been economically wasted in remote areas, having a very poor future for industrial use. It is foreseen that economic concentration of future plantations will be given priority for available funds.

Those forestry projects to be established outside the Forestry Districts will not benefit from the possible increase of amounts deductible, and in addition will yearly continue to decrease the percentage by 2.5% of the amounts deductible from the income tax incentives. In addition to the disadvantages, the investor outside of the Forestry Districts must complete the funds necessary by supplying 50% of the total amounts needed out of his own pocket. Therefore, the disadvantages outside the Forestry Districts become so great that the result will be channeling all available incentive funds into the Forestry Districts which are destined to supply new and existing pulp and paper mills.

8. However, before any foreign company can develop its own forests it must have written approvals from the Ministry of Agriculture's Land Institute (INCRA), showing the purpose for the land ownership.

9. The reforestation tax program has been instrumental in expanding forestry in Brasil to the extent of the following areas:

STATES	HECTARES	ACRES
Sao Paulo	495,346	1,223,507
Parana	377,223	931,741
Minas Gerais	392,441	969,330
Santa Catarina	177,500	438,425
Mato Grosso	107,217	264,826
Rio Grande do Sul	91,346	225,625
Espirito Santo	86,516	213,694
Goias	24,819	61,303
Bahia	15,993	39,503
Others	13,670	33,765
TOTALS	1,782,071	4,401,719
Planted to date by Olinkraft Ltda. —		
With Tax Incentives	31,000	77,000
Without Tax Incentives	3,000	8,000
TOTAL	34,000 Hectares	85,000 Acres

On the whole, the government reforestation tax program has been beneficial to Brasil by providing a new raw material resource base under the forest products industry in several sections of the country. It is quite possible that the peak of this tax incentive plantation program has been passed as project restrictions in Brasil have in recent years grown in complexity and agency approvals have become increasingly difficult to obtain. Also, as noted, government IBDF payments for reforestation projects were substantially delayed for the past year due to Brasil's monetary problems. No doubt exists that in the first years of the present decade (1970-1973) the tax reforestation program provided a major stimulus to plantation establishment in Brasil.

Mr. WHITE. Also a brief statement by the National Association of State Foresters prepared by Florida State forester John Bethea.

Mr. ROSTENKOWSKI. It will be made a part of the record.

[The following was submitted for the record:]

STATEMENT OF JOHN BETHEA, FLORIDA STATE FORESTER, NATIONAL ASSOCIATION OF STATE FORESTERS

My name is John Bethea. I am State Forester of Florida, a Member of Legislative Committee of National Association of State Foresters. I welcome this opportunity to appear before this Committee as a representative of the National Association and to offer our views on H.R. 4498 and 5798. We are convinced that tax incentives in some form is a viable means of encouraging landowner investment in forestry.

Recently, the National Association of State Foresters conducted a series of conferences to determine from forest landowners and other knowledgeable people what kinds of government policies and programs would be most useful to provide incentives and other assistance for better management of the private forest land. The need for these conferences was based on the knowledge that although 58 percent or 284 million acres of commercial forest land is held by nonindustrial private forest landowners, they are producing timber growth at a very low rate and they have the highest growth potential of any of the forest ownerships in the United States.

This was further recognized when last week President Carter transmitted to the Congress a policy statement, an assessment of the Nation's renewable resources, and the Secretary of Agriculture's recommended program for Forest Service activities. His statement of policy affirmed the need for increased productivity in private forests and he has asked for a program of beefed-up incentives and aid for timber growth on State and private forest lands.

The assessment is right on track with the message brought forward by landowners at our four regional conferences and the one national meeting held here in Washington. Private landowners were clearly concerned as calls for tax relief came through loud and clear from all regions. It was universally identified as the most important need along with technical assistance and information.

The National Association of State Foresters is convinced that a tax credit to landowners who make investments in their forest land would serve as a catalyst to increase the level of investment on these lands and thereby increased the productivity of the privately-owned forest land. There are many factors which have contributed to the low level of investment by nonindustrial private forest landowners in forestry. The length of time planning to harvest, the risks of fire loss, insects and disease, and the high cost of reforestation are examples. To help offset these factors a tax credit, such as proposed in these bills, would allow landowners to immediately recover portions of their cost of reforestation or forest improvement. This would alleviate one of the principle concerns that landowners highlighted at these conferences. Further, it would serve as a major incentive toward encouraging landowners to increase the productivity of their lands and produce the goods and services this country will need by the turn of the century.

Mr. WHITE. This concludes my remarks. Thank you for the privilege of participating.

[The following was subsequently received:]

FOREST INDUSTRIES COMMITTEE ON
TIMBER VALUATION AND TAXATION,
Washington, D.C., June 30, 1980.

Hon. AL ULLMAN,
U.S. House of Representatives,
Washington, D.C.

DEAR CONGRESSMAN ULLMAN: On June 26, 1980, hearings were held on a variety of tax bills before the Subcommittee on Select Revenue Measures of the House Ways and Means Committee. One of the bills considered at that time, H.R. 4498, deserves to be supported and expanded.

H.R. 4498 would provide for a 25 percent investment tax credit on the first $50,000 of capitalized reforestation expenditures and a 10 percent credit on amounts over $50,000. As can be seen from the enclosed copy of our testimony on H.R. 4498, we support the bill and hope that it can be expanded to include 7-year amortization of capitalized forestry expenditures. This is the approach taken in S. 100, Senator Packwood's reforestation proposal, which has 40 cosponsors and has been approved by the Senate Finance Committee.

The following are the principal reasons why we consider it vital that a meaningful reforestation incentive be enacted this year:

There is an immense need for increased investment in forestry. The Forest Service projects that the demand for paper and wood products will reach 28.3 billion cubic feet in the year 2030, up from 13.3 billion cubic feet in 1976.

Although timber capital gains provides the major incentive for timber growing, nonetheless, timber owners also need investment capital at the beginning of the growing cycle. The need is particularly great since planting cost investment is illiquid, subject to high risk, and must be held over the long periods between planting and harvest.

The Forest Industries Council's "Forest Productivity Report" found that on private nonindustrial lands, only approximately one out of every nine harvested acres were being purposefully regenerated.

A tax incentive which combines a tax credit with 7-year amortization would equate the tax treatment of timber investments with the treatment provided for investments in machinery and equipment. Planting expenditures are to timber as plant and equipment are to other industries and a credit plus amortization recognizes this similarity for tax purposes.

In all free nations which we have studied, laws have been enacted to give private owners incentives to plant forests and to keep them productive. Brazil provides an excellent example of the results of a significant tax incentive. Beginning in 1967, a law providing for a generous tax credit for reforestation encouraged the planting of four and a half million acres of new forests in eight years. This one act has made Brazil a contender in the future pulp and paper markets of the world.

Thank you for your consideration.

Sincerely,

ANDREW C. SIGLER, *Chairman.*

FOREST INDUSTRIES COMMITTEE ON
TIMBER VALUATION AND TAXATION,
Washington, D.C., July 14, 1980.

Hon. DANIEL ROSTENKOWSKI,
Chairman, Subcommittee of Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, Longworth House Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: In its testimony before the Subcommittee on Select Revenue Measures on June 26, 1980, the Treasury Department attempted to establish that tax incentives for reforestation would (1) not be cost effective and (2) would be in addition to "already substantial tax subsidies provided to timber growing".

The arguments presented to show that the subject incentives would not be cost effective appear to be without foundation.

Perhaps the best test of effectiveness would be to examine situations where similar incentives have been employed. In Brazil, for example, experience with such incentives has been highly successful. They are widely recognized as having been responsible for the establishment of timber plantations totaling over four million acres.

This experience of foreign countries is consistent with the opinion of landowners, forestry consultants and others who have studied the question. In this connection I am taking the liberty of enclosing a copy of the testimony of the American Forestry Association which was not available at the time of the June 26 hearing.

The balance of the Treasury testimony was based on a February, 1979 Treasury study which purports to confirm the Treasury's position that the timber industry is already highly favored with tax benefits. A review of the enclosed Forest Industries Committee on Timber Valuation and Taxation analysis of this study will substantiate our objections to the testimony. Briefly:

1. The study states that annual costs such as property taxes and interest should be capitalized and not be currently deducted in accordance with statutory authority. The study further argues that timber management expenses should not be

currently deducted. Disallowance of such expenditures would discriminate against timber owners since maintenance expenses of other capital assets are currently deductible; and it would operate as a substantial disincentive for forest growth at a time when the nation is in severe need for greater not less forest investment.

2. Since current expensing of timber management costs is proper and normal, the "tax benefits" enjoyed by timber owners is not the 35–43 percent of the value of standing timber referred to in the study, but it is only the benefit accorded by capital gains treatment itself. For corporations this amounts to 18 percentage points, the difference between 46 percent ordinary income rate and 28 percent capital gains rate and a corresponding differential applies to individuals.

Congress has repeatedly examined and reexamined the timber capital gains feature of the tax law and has concluded that it properly be retained. The enclosed brochure states many of the reasons why Congress has reacher this conclusion.

3. The study suggests that by virtue of the ability of timber owners to expense the cost of timber management against current income rather than against capital gains, timber owners are "converting" ordinary income into capital gains and thus paying a lower tax than is proper.

When Congress enacted timber capital gains in 1944, it specifically did not require that timber management expenses be disallowed as a deduction from ordinary income. To require such a disallowance now would be inconsistent with Congress' purpose in having granted the timber capital gains incentive initially. Such a disallowance would reduce the very benefit Congress extended in the first instance.

4. The study has obviously not been prepared by persons knowledgeable in the timber economy. It uses some data which are totally unrealistic. For example, the formula used produces market values over 13 times greater than the values reported by the U.S. Forest Service. Similarly, it includes as a key element in its analysis costs which occur only in rare instances. Land rental is the best example of this, but it applies also to other items.

Every private and public forecast of timber needs and availability shows a serious shortfall in timber supply within the next few decades. The investment requirements to improve that supply are substantial. They amount to more than 10.3 billion dollars on the 139 million acres of forest land which have been identified by industry sources as presenting economically feasible opporutnities for improved growth. And more needs to be done on acreage which has not yet been studied.

Thus, if our future housing and other essential fiber needs are to be met, it is vital that the incentives provided for in this legislation be adopted.

Thank you very much for your consideration of these views.

Sincerely,

ANDREW C. SIGLER, *Chairman.*

Enclosures.

RESPONSE TO TREASURY STUDY

The following are observations and analyses of the timber portions of the study produced by the Office of Tax Analysis titled "Federal Tax Policy and Recycling of Solid Waste Materials" dated February 1979. The study concludes that the timber industry is in a "favored position" from a tax standpoint relative to other industries. In support of this conclusion, the authors have relied on a litany of arguments which have been utilized by Treasury or Treasury officials for years—arguments which have repeatedly been shown to be without substance.

Relying on a highly suspect formula approach (the so-called "cost pricing" method), the study solves for an estimated sales realization for timber based on certain costs that are incurred. The study claims that the timber industry benefits from special tax provisions in three areas: 1) mismatching of income and expense, 2) deduction of expenses against other ordinary income, and 3) taxation of income from the sale of timber at capital gain rather than ordinary rates. By isolating these three purported benefits, the study concludes that these benefits are equivalent to a direct cash subsidy of from 35 to 43 percent of the value of standing timber before harvest. These results are grossly misleading and this paper will explain why.

The key underlying issue is whether the tax laws treat a timber investment more favorably than they do any other capital asset. If they do not (and we believe this to be the case), then the Treasury position has no merit. It is the purpose of this paper to summarily rebut the Treasury position.

METHODOLOGY

The formulas used in the report, while mathematically correct, are based on invalid reasoning. They incorporate an underlying assumption that revenues are determined by costs and controlled by a predetermined rate of return. This ignores the fact that revenues are determined by the market place and not by a producer's cost. A comparison of realistic timber market values (as reported by the U.S. Forest Service) with the timber market values calculated by the formula indicates that the formula-derived values are over 13 times greater than actual values. This distortion is significant enough to invalidate the revenues calculated in the formula.

A second questionable area of methodology involves two cost items which are included in the formula—land rental and clearing of site. Generally, timber owners do not rent land, but own it. If this cost is intended to represent "economic rent", it is still inappropriate since no tax deduction is permitted for hypothetical costs. Clearing of site is also incorrectly included as a cost, since it would only occur in isolated instances. Site clearing, as opposed to site preparation (which is already included in the formula), is only performed when a totally overgrown hardwood stand is converted to pine or when the operator is shifting from timber growing to some other utilization of the land.

The third problem area with the methodology is the comparison of the current law with a "neutral" tax case. This "neutral" tax case eliminates the three items mentioned earlier which the Treasury maintains are special tax benefits to the timber industry. However, the "neutral" tax concept would not place timber on an equivalent basis with other industries, but would instead penalize it by taking away tax characteristics which are universally available to all corporations and individual businesses. Each of the three purported special benefits are discussed below.

The concept of mismatching of income and expense is an academic consideration and does not relate to the clear intent of Congress to allow certain deductions on an annual basis, as expressed in the current tax code. It is idealistic to argue that certain annual expenses (i.e., property taxes, etc.) should be capitalized for 20 to 30 years for timber when property taxes and carrying charges are uniformly deductible by all taxpayers.[1] There is no basis for subjecting timber owners to a different rule. Furthermore, these taxes, interest, and maintenance costs are paid to discharge an *annual* obligation, and as such their treatment is fully in accord with the proper application of the matching principle. They are current expenses which if not paid would result in the total loss or loss in value of the underlying asset. Clearly, then, they must be paid to *maintain* such asset and it would be inappropriate to capitalize them. The courts have consistently agreed with this viewpoint.

We can thus see that the entire mismatching argument has little or no relationship to the realities of forestry taxation. This mismatching concept is dependent on a finding that capital costs have somehow been misclassified as ordinary expenses in the case of timber. As the above discussion demonstrates, however, exactly the opposite is the case. It is clear that no "special rule" is applicable to timber growers which is not applicable to other capital investors. The tax accounting rules applicable to timber offer no special break or advantage. The courts, the Internal Revenue Service, and general accounting principles all recognize that the ongoing expenses of maintaining a capital asset, be it timber or otherwise, are properly deductible as current ordinary and necessary business expenses and only those expenses incurred to acquire or establish that asset are to be capitalized. This is precisely the practice followed by timber owners.

The second item cited by the Treasury study in the use of the "neutral" tax case is the deduction of timber related expenses against other ordinary income as opposed to capitalizing them. This argument contends that the so-called mismatching of income and expense, when coupled with capital gain treatment upon ultimate disposition, results in the timber owner converting ordinary income into capital gain income, and receiving an unfair advantage. This conversion argument rests on a shaky foundation because it is totally dependent on the ill-conceived mismatching argument. Since the mismatching argument has been demonstrated to be fallacious, the conversion argument is without substance.

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[1] The singular exception being the recent enactment of a provision requiring capitalization of these expenditures during a short construction period for real estate. This unique provision is expressly aimed at a tax shelter situation, which is clearly not the case for timber growing.

The study also combines the "mismatching" and "conversion into capital gains" arguments and attempts to demonstrate that the interrelationships of these two items can shift an otherwise unprofitable venture into a profitable one. The following example was used in the study by the Treasury Department to support this argument.

Suppose that a corporation is engaged in both timber growing and logging or manufacturing. An expense of $100 in timber growing can be deducted against revenue from logging or manufacturing in computing net taxable income. If the $100 expense eventually produces $100 of revenue from the sale of timber, the corporation's taxable capital gain increases by $100. Because corporate income is taxed at a 46 percent marginal rate, while corporate capital gain is taxed at a 28 percent rate, the expense which produced a net income of zero has created a tax savings of $18.

Ignoring for the moment that both of the underlying arguments are demonstrably in error, the above illustration, which appears so persuasive at first glance, falls completely apart when the time value of money is taken into account. In the example, the taxpayer will receive $72 when he sells his timber ($100 of revenue less $28 of taxes). The *when* part of the equation is critical, however, and the example chooses to totally ignore this point. The present value today of money received in the future is, of course, considerably less than the face amount of the money that is received. For example, assuming a current inflation rate of 10 percent, the equivalent value of $72 received 15 years from now is only $17.24 today. If the $72 is received 20 years from now its value today is $10.70, and 30 years from now it is worth only $4.13. These after-tax future returns must be compared to the after-tax current outlay per the example of $54 ($100 of expenses less $46 of tax savings). Thus the current dollar *loss* on this investment would range from $36.75 to $49.87! The Treasury Study simply ignores the fact that it takes time to grow a tree.

The final issue raised by the study in connection with the concept of "neutral" tax, is directed at the capital gains treatment afforded the sale or harvest of timber. The question here is not whether timber is properly includable as being eligible for capital gains treatment, but why, as the study implies, is timber receiving a special benefit? The law is quite clear on the issue that timber is considered a capital asset and therefore subject to all regulations and/or benefits accruing to capital assets. Clearly, timber receives no unique benefits which are distinguishable from those afforded any other capital asset.

The broader question of whether timber *should* be classified as a capital asset can be answered by simple reference to the supporting evidence underlying the original enactment of Sec. 117(k) and all of the multiple intervening intensive reviews by the congressional tax writing committees. It has been absolutely established that timber is a socially necessary commodity which does not have a viable economic substitute. It is unique in that it is physically renewable. However, it must also be *economically* renewable in order to stimulate the required investment in the reforestation activities. There must be an adequate profit motive to attract capital investments in timber. Federal Trade Commission reports indicate that even *with* the capital gains benefits, the returns from timber investments lag behind those of "all manufacturing" and "nondurable goods" categories. This is further evidenced by a significant lag in investments by nonindustrial timberland owners.

CONCLUSION

The Treasury Report has stated that the tax treatment accorded timber owners is based on special rules which do not apply to other taxpayers. This criticism is not well founded. It fails to acknowledge history, and either misconstrues or misstates the tax and accounting principles applicable to timber taxation. More important, the criticism ignores the inherent nature, both economic and physical, of timber itself. In doing so, the critics have reached unrealistic conclusions as to the best means of pursuing a national policy which encourages timber supply.

It is this national policy, however, which should be kept firmly in mind. Timber is a unique renewable resource and has tremendous potential as a fundamental raw material which can be available at an acceptable price. None of this potential will be realized without a consistent national policy of tax incentives which encourage capital investment in timber by assuring those making such investments a reasonable rate of return in the future.

Mr. Rostenkowski. Thank you, Mr. White. I would like to express the appreciation of the committee for your general statement and participating in the discussion.

Any questions of the gentlemen?

Mr. Jacobs?

JOINT STATEMENT OF HON. ANDY JACOBS, JR., A REPRESENTATIVE IN CONGRESS FROM THE STATE OF INDIANA, AND JOHN D. DINGELL, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

Mr. Jacobs. Our testimony is exactly the same as it was when we appeared before the committee before. We have submitted a new bill to meet some changes, the new bill being H.R. 7318. It continues the existing exemption, or that is to say, continues the existing law allowing deductibility for easements for conservation purposes. It authorizes such easements to be given where the owner of the property reserves mineral rights; that is, to mine the gas and other mineral interests while the surface is used for conservation purposes—that is, any kind of mining except strip mining which would not be allowed under the deductibility.

Our new bill makes two changes that were suggested by the Treasury Department which we agree with. One is to limit the types of easements to publicly supported organizations and second to eliminate the deductibility of perpetual lease donations or options donated for conservation purposes. The Treasury has also suggested that the deduction should not be allowed in cases where the public did not have general access to the easements. In our opinion that is unreasonable in that the purpose of these easements quite often is to preserve wildlife and so long as the wildlife has access to it the public does benefit generally. Other conservation groups are going to testify today that they believe the law should specify the definition of conservation used to include open space and farmland. Mr. Dingell and I endorse those proposals as well.

That is about it, Mr. Chairman.

[The prepared statement follows:]

Joint Statement of Hon. John D. Dingell, a Representative in Congress From the State of Michigan, and Hon. Andy Jacobs, Jr., a Representative in Congress From the State of Indiana

We are most appreciative of the Subcommittee's continuing interest in legislation we introduced last session to provide tax incentives for the donation of land and interests therein for conservation purposes. The proposal, H.R. 7318 now before the Subcommittee, maintains the basic thrust of our original bill, H.R. 4611, on which the Subcommittee heard testimony last year. Specifically, H.R. 7318:

(1) Amends the Tax Reform Act of 1976 by removing the June 14, 1981 expiration date for the deductibility of easements given for conservation purposes defined in section 170(f)(3)(C) of the IRS Code; the effect of this change is to enable deductions for easement gifts to continue;

(2) Authorizes deductions for gifts of surface land by owners who retain their oil, gas or other mineral interests; access to such minerals is also permitted except by strip mining methods.

The need for continued tax incentives for the donation of land is great. In an age of fiscal austerily, it is neither possible nor desirable that every acre of significant land be purchased in fee. Congress, for example, is in the process of appropriating only thirty seven percent of the authorized appropriation for the Land and Water Conservation Fund for fiscal year 1980. For fiscal year 1981, the House has recommended a funding level of $391 million, roughly the same level of funding.

Does this mean that significant resource areas meriting conservation are not to be found? To the contrary, there are many resources of historic, natural, or scenic significance which should be conserved either through fee acquisition or donations. Passage of this bill will enable public conservation agencies and private nonprofit conservation groups to seek more donations of land in these fiscally austere times—a goal I think the Congress should strongly support.

H.R. 7318 also contains provisions suggested by the Department of the Treasury. The effect of these provisions is to (a) limit the types of nonprofit organizations and (b) to eliminate the deductibility of perpetual leases and options donated for conservation purposes. These provisions were suggested by Treasury to restrict the potential for abuse of the easement program.

Treasury has also suggested several other changes to H.R. 7318, which we rejected as inconsistent with the bill's purposes. The most harmful of their suggestions was that public access be required to easement areas before the donor would be allowed a deduction. Such a requirement, in our opinion, would eliminate most easement donations.

Easements are attractive to private land owners because they can retain control over their property. At the same time, the owner makes a contribution to conservation by permanently giving up certain uses of the property. The benefit to the public lies in the preservation of significant resources such as wildlife habitat. Besides, if public access to a particular resource is desirable, the area is usually purchased in fee and managed by a government agency.

The Secretary of Interior has aptly made the case against access to easement areas in a letter to the Secretary of the Treasury. I would like to submit Mr. Andrus's letter for the record.

Another recommendation by Treasury was that the existing definition of conservation purposes in the Tax Reform Act of 1977 be changed. We saw no reasons to deviate from the existing law which defined conservation purposes as:

> "(i) the preservation of land areas for public outdoor recreation or education, or scenic enjoyment"
>
> (ii) the preservation of historically important land areas or structures; or
>
> (iii) the protection of natural environmental systems."

However, several conservation groups to appear before the Subcommittee today will suggest that a fourth category be added to the existing definition to cover open space and farm land conservation provided that farm conservation easements are in furtherance of a local, state, or national program or policy. We have no objections to this amendment. In fact, it is quite clear that open space easements qualify now under the existing law, but clarification of this point would be helpful.

To conclude, we hope the Subcommittee will act favorably on H.R. 7318. It has the support of national conservation organizations such as the National Audubon Society, The Nature Conservacy and the National Wildlife Federation. The Secretary of Interior is also in favor of the bill. Finally, our colleague, Congressman Fisher, has expressed his support for the legislation and asked us to enter his statement for the hearing record.

Mr. Rostenkowski. Thank you, Mr. Jacobs.

The legislation that you have introduced and the predecessor legislation have forced us to look at partial gifts. I think what concerns me in this is the criticism that the retained mineral rights provision will result in large tax deductions for the holders of mineral rich property whose only gift really is that property that they don't want, but yet retain in all the rights under that property. That is very difficult for me to accept. Would you like to make some comment, Mr. Jacobs? How can you answer questions like that?

Mr. Jacobs. Yes, I appreciate the opportunity of doing it. Most gifts are things that people don't want too much or they would not be giving them away with all due respect to the generosity. It may be true that something I give to charity is of less use to me than it is to the charity that I give it to and I still get the tax deducation.

No. 2, I suppose that in many cases the mineral rights or the mineral value is speculative, it may never materialize in terms of profit to the owner of the land. I believe those would be the two answers that Mr. Dingell and I would submit for the record, Mr. Chairman.

Mr. ROSTENKOWSKI. I am sure that the gentleman from Indiana asks unanimous consent that Mr. Dingell's prepared statement be included in the record.

Mr. JACOBS. I thank the chairman very much. I do ask unanimous consent that the prepared statement by Mr. Dingell and myself be included.

I would also ask, Mr. Chairman, if a letter which I will submit for the record under date of June 5 from the Secretary of the Interior to the Secretary of the Treasury essentially endorsing our legislation be included for the record.

Mr. ROSTENKOWSKI. Without objection, so ordered.

[The letter follows with the Treasury Department response:]

DEPARTMENT OF THE TREASURY,
Washington, July 25, 1980.

Hon. CECIL D. ANDRUS,
Secretary of the Interior,
Washington, D.C.

DEAR CECE: Thanks for your recent letter concerning H.R. 7318. While your letter is dated June 5, 1980, you should be aware that it was not delivered to the Treasury until June 18, and that it since has been circulated to interested members of Congress and made a part of the hearing record before the Subcommittee on Select Revenue Measures of the House Ways and Means Committee.

H.R. 7318 would make modifications to and eliminate the sunset date of those provisions of the Internal Revenue Code that authorize deductions for charitable contributions of certain partial interests in property (such as easements) made exclusively for conservation purposes. Daniel I. Halperin, Treasury's Deputy Assistant Secretary for Tax Legislation, presented the Administration's views on this bill before the Select Revenue Measures Subcommittee on June 26.

The Treasury's June 26 testimony incorporated revisions made after consultation with representatives from the Office of Management and Budget and the Department of Interior. As set out in the testimony, the Treasury is willing to consider the public benefits that may flow from contributions of easements as encompassing not only public accessibility to land, but also the preservation of important wildlife habitat and land of scenic value to the general public.

At the same time, there are compelling reasons to tread carefully in framing legislation to allow the continuing deductibility of contributions of conservation easements. This is so because of the difficulties of drawing the line between those interests in property that fulfill a substantial conservation purpose and those whose value is questionable, and the substantial possibilities for tax abuse that inhere in the availability of deductions for contributions of easements.

Treasury representatives would be pleased to work with your staff in an effort to work out mutually acceptable legislation. Such a solution perhaps could involve a process of certification of interests eligible for tax deductions. I sincerely hope that a proposal can be developed that will accommodate the goals of your Department while satisfying Treasury's concerns.

Best wishes.

Sincerely,

G. WILLIAM MILLER,
Secretary.

U.S. Department of the Interior,
Office of the Secretary,
Washington, D.C., June 5, 1980.

Hon. G. William Miller,
Secretary of the Treasury,
Washington, D.C.

Dear Mr. Secretary: As your Department considers tax policy questions involved with H.R. 4611 and H.R. 7318, I wish to affirm the strong support of the Department of the Interior for the utility of conservation easements as a valuable tool in achieving the purposes of habitat protection for the nation's fish, wildlife and plant resources. The Department relies heavily on the use of easements in specified situations as the best approach to conserve land.

In addition, the Department strongly supports the existing provisions of the tax code which enable landowners to receive Federal tax deductions for easements given for conservation purposes. The Department depends on the actions of private, nonprofit organizations to protect lands worthy of conservation which for various reasons the Department is unable to protect. The existing conservation easement deduction program is working well to protect important natural resources and should be established on a permanent footing; hence we support the elimination of the program's June 1981 expiration date.

The use of a conservation easement for natural resource protection usually occurs where the acquisition of fee title may either be unfeasible or uneconomical. In many cases, private landowners are willing to permanently relinquish certain interests in their land for conservation purposes, yet they have a strong desire to retain ownership and control of their property. Private landowners have been willing to sell or donate conservation easements because the easement does not mandate the intrusion of the general public onto their lands; yet the public most certainly benefits from the easement because natural resources are being perpetually protected. For example, a Nebraska farmer who gives a perpetual easement over wetlands on his farm to protect the feeding or roosting habitat of migratory waterfowl contributes to the maintenance and protection of migratory birds using the Central Flyway, a goal mandated by Federal Wildlife statutes. While the public does not have a direct access to the farmer's property, the general public benefit is clearly served by the easement. In addition, the easement appproach keeps the farmer's land on state and local tax rolls, and costs the Federal government less than outright acquisition.

Easements have been used by the Department for a long time, and we expect their use to increase as the Federal budget for fee acquisition decreases. The Fish and Wildlife Service, for example, has already protected approximately 1.1 million acres of prairie wetlands in the Midwest for migratory bird conservation through the use of the conservation easement. A similar program is now underway in California with the goal of purchasing 50,000 acres of easements to protect a major wintering area along the Pacific Flyway. To date, the Fish and Wildlife Service has acquired 1,200,000 acres of easements in five states.

The Park Service also utilizes easements where appropriate. At the Nez Perce National Historic Park, for example, the Congress directed the Park Service to acquire half the needed land in fee and half in easements. Also, under the Wild and Scenic Rivers Act, the National Park Service and Forest Service are directed to acquire more river corridor acreage in scenic easements than in fee acquisition.

Achieving Federal land conservation objectives has always depended on a mix of government and private, nonprofit action. Easements on important tracts of land have often been donated to conservation organizations such as The Nature Conservancy or the Trust for Public Land. I expect our dependence on the private sector to acquire more easements will increase during the 1980's. The Interior Department simply cannot protect all significant natural resource areas through fee acquisition and management; we are counting on nonprofit conservation organizations to assist us. And with appropriations under the Land and Water Conservation Fund dwindling, the acceptance of easements by 501(c)(3) conservation organizations will become more vital if the nation is to adequately protect its native plants, animals and the ecosystems made up of those plants and animals.

I urge you to give careful consideration to the resource protection goals advanced by H.R. 7318, and I urge your Department to work with this Department to develop an Administration position on H.R. 7318 that supports those goals.

Sincerely,

Cecil D. Andrus, *Secretary.*

Mr. Rostenkowski. I want to thank personally Mr. Jacobs and Mr. Dingell for the time and effort they displayed in this legislation. I would hope that we come to some new-found resolve on this legislation and that we can work out the remaining problems that we recognize to exist.

Are there any questions?

Thank you very much.

Mr. Jacobs. I thank the committee, Mr. Chairman.

Mr. Rostenkowski. Mr. Joseph Minish?

Mr. Minish, we look forward to your presentation.

STATEMENT OF HON. JOSEPH G. MINISH, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW JERSEY, ACCOMPANIED BY COL. CLINTON PAGANO, SUPERINTENDENT, NEW JERSEY STATE POLICE

Mr. Minish. Thank you very much, Mr. Chairman.

First of all, I know the committee has a lot of work before it, and I assure you, as I told you earlier, my speech will take about 150 seconds. I have with me Colonel Pagano, who is the head of the New Jersey State Police.

I appreciate the opportunity to testify on H.R. 6935. This legislation is designed to correct an apparent oversight in Public Law 95–427 by codifying unmistakably the intent of Congress in that law.

Congress passed Public Law 95–427 in response to the 1977 Supreme Court *Kowalski* decision that subsistence allowances given to State police officers in 15 States do constitute taxable income. Up to that time, on the basis of a 1954 Court of Appeals decision, thousands of troopers all over the country had not included these allowances in their taxable income. Congress passed Public Law 95–427 by a vote of 386 to 12 in the House because it recognized that the troopers who had continued to exclude subsistence income from their taxes during the lengthy *Kowalski* litigation period of 1970 to 1977 had become liable to back tax assessments which in many cases would have been crippling. The law directed that the taxation of subsistence allowances should begin as of the 1977 decision. Thus troopers who had excluded this allowance from their taxable income in accordance with the 1954 decision were relieved of the prospect of disastrous tax payments and possible bankruptcy.

Some troopers, however, had included such income in their tax returns all along on the advice of the Internal Revenue Service. Acting on Public Law 95–427, IRS uniformly granted refunds to these taxpayers, who had filed amended returns for the disputed years up to the 1977 decision. In New Jersey, however, a particular problem arose.

The Newark office of the IRS had advised troopers who included their subsistence allowances in their taxable income that they could keep the matter open pending the outcome of the court case simply by filing form 872, an in-house IRS time extension form, instead of filing amended returns for the years in question. After the court decision and the subsequent passage of Public Law 95–427, these troopers learned that the advice which they had received from IRS was no longer applicable; it soon became apparent from the IRS interpretation of Public Law 95–427 that the forms 872 did not guarantee them the refunds for 1974, 1975, and 1976 which the amended returns would have guaranteed. Having paid their taxes and followed IRS advice to the letter, these 200 or so troopers are now denied the refund which their colleagues all over the country have received. Even those taxpayers who did not cooperate with IRS were able to keep this money, but those who were most cooperative are still denied it.

The Treasury Department concedes that this latest IRS ruling is not compatible with the intent of Public Law 95–427 but says it cannot rectify matters without corrective legislation. Assistant Secretary for Legislative Affairs Gene E. Godley has given the New Jersey State office written confirmation that Treasury will not oppose legislation which would relieve these few taxpayers, who should be allowed refunds to achieve treatment equal to that given their colleagues by Public Law 95–427. Recognizing an inequity, Treasury will not oppose appropriate legislation to remedy it.

H.R. 6935 is strictly limited to these taxpayers only and to their returns for 1974, 1975, and 1976 only. It will allow these 200 or so individuals who extended their returns by form 872 to get the same treatment as their colleagues received under Public Law 95–427. Because this particular situation is so unique and circumscribed, it will not create havoc with the principle of a statute of limitations to relieve these taxpayers.

Mr. Chairman, thank you very much for the opportunity of appearing here. I will be pleased to answer any questions you might have.

Mr. Rostenkowski. Thank you very much, Mr. Minish.

Are there any questions of the gentleman?

Mr. Guarini?

Mr. Guarini. We also had testimony from the head of the New Jersey police force, Colonel. I am very happy to have you here.

Mr. Pagano. Thank you.

Mr. Guarini. It might be comforting for you to know that Treasury had testified earlier on its willingness to go along with this bill, Mr. Minish, and that there is no way that we should penalize the good people who had followed the IRS advice. So I think that we should see that some justice is done.

Mr. Pagano. Thank you very much, Mr. Guarini.

Mr. Minish. Thank you very much, Mr. Chairman and members of the committee.

[The prepared statement follows:]

Statement of Col. Clinton Pagano, Superintendent, New Jersey State Police

Thank you, Mr. Chairman . . . I appreciate this opportunity to appear before this committee to express my beliefs as Superintendent of the New Jersey State Police concerning the application of I.R.S. rules promulgated to implement Public Law 95–427. So it is with this in mind that I appear today to support passage of legislation to amend Public Law 95–427 which will enable certain New Jersey State Police officers to qualify for a refund of federal income taxes paid on their subsistence allowances prior to January, 1978.

As you know, Public Law 95–427 was approved and signed by the President of the United States on October 7, 1978. This legislation was introduced and lobbied by all the States as a result of the United States Supreme Court case of "Commission vs. Kowalski" decided on November 29, 1977. In that decision the Supreme Court held that cash meal allowance payments received by State Troopers are includible in gross income. As a result, subsistence allowances received by State Police officers are subject to Federal Income Tax.

Prior to this Supreme Court 1977 decision, it was left to the discretion of the individual State Trooper as to whether or not he will include the subsistence allowances in his taxable income. Consequently, for those years during the Kowalski litigations (1970–1977), there basically emerged three classes of State Trooper tax payers.

The three classes referred to are:

1. Those Troopers who opted to include the allowance on the tax return, and those paying taxes on it;
2. Those Troopers who did not include allowance on the tax return and thus paid no tax on it;
3. Those Troopers who initially did not include the allowance and were subsequently audited by I.R.S. and made to pay the abatement.

Those Troopers who fall in Class 1 are now referred to as "White Hats", the Troopers who followed I.R.S. instructions and procedures, included maintenance as income and paid the appropriate taxes.

During the period in which the Kowalski case was litigated, the Newark, New Jersey, office of I.R.S. advised the New Jersey State Troopers to pay taxes on their allowance and claim no offset deductions. In addition, the District I.R.S. office recommended that Troopers refrain from filing 1040–X Claim Forms but rather complete Form 872 (Consent Form fixing period of limit upon assessment of Income Tax).

Public Law 95–427 provided in part for the filing of I.R.S. Form 1040–X to obtain refunds for taxable years 1974, 75 and 76. However, the Director of the I.R.S., Newark office, indicated that submission of the 1040–X Form created a great burden on his office and advised that it would not be necessary for present or former members of the New Jersey State Police to file 1040–X Form by April 16. 1979. This advice was contained in a letter from Director Coleman to Superintendent Pagano dated March 29, 1979. Once again the "White Hats" complied with the official instructions of the I.R.S. and did not inundate Newark I.R.S. office with several thousand 1040–X Forms.

However, these 872 Forms were not recommended for completion until the three-year grace period for that taxable year had expired. A number of New Jersey State Troopers, therefore, did not file Form 872 for tax years 1974, 1975 and 1976 until after the November 29, 1977, Kowalski deadline. Then under the provisions of the revenue procedures promulgated, these individuals have been denied a refund for taxes paid; while others, who paid no tax or claim offsetting deductions contrary to the policy espoused by the I.R.S., are not obligated to pay the tax. This clearly is contrary to the original congressional intent of Public Law 95–427, which was to make the Kowalski decision prospective only.

As Superintendent of the New Jersey State Police, I believe the intent of Public Law 95–427 is clear. I cannot believe that members of the New Jersey State Police are to be denied proper relief due to I.R.S. procedural differences and interpretations apart from the spirit and intent of the law.

This proposed amendment would insure that the New Jersey State Troopers and their families receive a fair tax treatment they had anticipated and deserve, and I strongly urge its endorsement by this committee.

Mr. Rostenkowski. Mr. Coughlin, Mr. Chandler, and Ms. Gerard, welcome to the committee. We appreciate the time and effort you displayed in joining us this morning and testifying on legislation in which you show an interest. If you would identify yourselves and then proceed into your testimony we will begin with Mr. Coughlin and Mr. Chandler and then Miss Gerard.

STATEMENT OF THOMAS A. COUGHLIN III, CHIEF COUNSEL, REAL ESTATE, NATIONAL TRUST FOR HISTORIC PRESERVATION IN THE UNITED STATES

Mr. Coughlin. Mr. Chairman and members of the subcommittee, my name is Thomas Coughlin. For the past 4 years I have served as real estate counsel to the National Trust for Historic Preservation. In this capacity I have been responsible for providing legal counsel to the trust in the administration of its preservation easement program.

The National Trust for Historic Preservation is a charitable, educational and nonprofit corporation chartered by Congress (16 U.S.C. sec. 468, et seq.) to further public participation in the preservation of sites, buildings and objects significant in American history and culture. On behalf of the trust's more than 165,000 individual and organizational members, I would like to record our qualified support for H.R. 7318. Although we recognize the need for amendment to insure that the full range of programs successfully operating under existing law will be protected under the new legislation, on balance we believe H.R. 7318 is a good bill which, with minor modification, will be a substantial improvement over existing code provisions.

THE TRUST'S EASEMENT EXPERIENCE

The national trust holds easements or other forms of deed restrictions on close to 40 historically important properties. Of these, all but four are national historic landmarks, national register properties, or properties located within national landmark districts. Six easements protect properties which, because of their substantial acreage, are not generally visible from public roads. The total acreage of properties protected by trust easements is slightly less than 1,000 acres.

Under the easement acquisition policy promulgated by our board of trustees, the president of the national trust is authorized to accept gifts of easements on properties of national significance, as evidenced by their designation as national historic landmarks; on properties of special historical, architectural or archeological significance or importance, or exceptionally representative of their period, design, style, type or designer and listed in the national register; or properties necessary to protect the foregoing or properties owned by the national trust. Although national landmark status or eligibility for the national register are considered by the trust in evaluating historic properties, the national trust has resisted linking its easement acquisition policy to such registers because such registers are incomplete and, in some cases, may not cover "buffer" areas necessary to protection of individual landmarks or districts.

All trust easements provide for periodic inspection by the trust and reserve to the trust legal and equitable enforcement remedies in the event of a breach. Absent evidence of violation inspections are performed annually.

Significantly, national trust does not require public access or public visibility. Acquisition of voluntarily contributed easements on selected properties enables the trust to fulfill its public charitable purposes by protecting for posterity important remnants of our cultural heritage. Although properties protected by trust easement are not legally subject to public access requirements, it has been our experience that most owners welcome the opportunity to make their properties available for educational research and controlled visits by responsible organizations.

EXISTING LAW AND NEED FOR CLARIFICATION

The value of donations of easements are presently deductible under two sections of the Internal Revenue Code: charitable gifts of an "open space easement in gross in perpetuity" are allowed as an "undivided portion of the taxpayer's entire interest in property" under IRC section 170(f)(3)(B)(ii) and the income tax regulations. Gifts of a "lease on, option to purchase, or easement * * * granted in perpetuity * * * exclusively for conservation purposes" are deductible under IRC section 170(f)(3)(B)(iii).

OPEN SPACE EASEMENTS IN GROSS

Prior to 1976 the requirement that open space easements be "in gross" to be deductible for Federal income tax purposes created real and perceived obstacles to preservation and conservation organizations attempting to acquire such easements. Because of arcane common law provisions in some States, easements "in gross" were not recognized. Virtually all States, by contrast, recognize equitable servitudes, so-called "appurtenant" easements, or similar land use restrictions. For purposes of section 170 of the Internal Revenue Code and accomplishing the goals of preservation organizations it makes no rational difference whether the property interest is characterized as an easement "in gross" or "appurtenant." Nevertheless the ability of taxpayers and preservation organizations to utilize open space easements and the Federal tax treatment accorded such use, depended solely upon variations in State law.

EASEMENTS FOR CONSERVATION PURPOSES

The 1976 Tax Reform Act expanded the category of partial interests that would qualify for a charitable contribution to include "a lease on, option to purchase, or easement * * * of not less than 30 years duration granted * * * exclusively for conservation purposes." Although the authority for gifts of easements of less than perpetual duration was repealed in 1977, expansion of the category of qualifying partial interests was a major improvement.

By eliminating the requirement that easements be "in gross" to qualify, Congress for the first time assured a degree of uniform tax treatment to gifts of easements, without regard to the labels attached to such interests under various State laws. Unfortunately, the effectiveness of the 1976 amendment has been blunted by the absence of income tax regulations interpreting easements granted for "conservation purposes." Since enactment of the 1976 amendment the Internal Revenue Service on several occasions has construed and upheld the deductibility of easements as "open space easements in gross." However, such rulings are of little value to taxpayers in jurisdictions where easements in gross are not recognized.

H.R. 7318

H.R. 7318 makes several improvements in the existing code provisions dealing with charitable gifts of partial interests for open space, land conservation, and historic preservation programs.

Under the real property laws of some States, the terms "covenants" or "servitudes" are preferred to "easements" in characterizing partial interests used for conservation and preservation programs. Substitution of a "restriction granted in perpetuity on the use which may be made of the real property" for a "lease on, option to purchase, or easement granted in perpetuity" will serve to conform the tax code to substantive real property requirements of virtually all States.

Authorization of a charitable contribution deduction where the only interest retained by the taxpayer is the right to extract subsurface mineral rights by environmentally sound subsurface extraction methods serves to correct an existing inequity in the code which presently allows a deduction to those who sell subsurface mineral rights before donating surface lands but denies a charitable contribution deduction for taxpayers who reserve subsurface mineral interests incident to a charitable gift of surface lands. We believe the proposed amendment will encourage gifts of environmentally sensitive surface lands while promoting exploitation of our scarce mineral resources in an ecologically sound manner.

We believe H.R. 7318 is a good bill, but we believe a change is essential to recognize open space easement programs operating under existing law.

Although there were substantive real property law problems posed by the term "easement in gross in perpetuity" under the laws of some States. Since 1964 the Internal Revenue Service has consistently upheld the deductibility of open space easements to protect a broad range of properties including historic properties, scenic lands, farm and forest lands, and natural areas.

There now exists a considerable body of published law in the form of revenue rulings, letter rulings, revenue procedures and court decisions construing and defining limits on the use of open space easements. Easements under the existing regulations are being used by local organizations to protect the diversity in size, scale and architectural style so typical—and essential—to providing a sense of time and place in urban areas. In rural areas, easements afford an opportunity to protect open space land, farmlands and large estates that would be beyond the means of local governments. We are concerned that, in restructuring the statutory authorization for charitable gifts of "restrictions" for "Conservation Purposes," as contemplated in H.R. 7318, Congress not nullify the substantial case law and practical experience gained from over 15 years of work by the Internal Revenue Service and affected preservation and conservation organizations.

This could be accomplished by a simple amendment to the definition of conservation purposes in section 170(f)(3)(C) of the Internal Revenue Code to expressly recognize open space easement programs or by a clear statement of legislative intent that in enacting H.R. 7318 Congress does not intend to rescind existing law.

In conclusion, Mr. Chairman and members of the subcommittee, I would like to state National Trust enthusiastically endorses elimination of the June 14, 1981 "sunset" date as proposed in H.R. 7318. Since enactment of the Tax Reform Act of 1976, we have witnessed an increasing interest in establishment of easement programs among our member organizations and believe that they are a cost-effective alternative to preserve and conserve our Nation's historic resources.

Mr. Rostenkowski. Mr. Chandler?

STATEMENT OF WILLIAM J. CHANDLER, LEGISLATIVE REPRESENTATIVE, THE NATURE CONSERVANCY

Mr. **Chandler.** Thank you, Mr. Chairman. The National Conservancy is a national, nonprofit conservation organization. We hav chapters in Tennessee, Illinois, California, and 26 other States in th Nation. Our basic purpose is to acquire land for conservation purpose which we scientifically identify and either file in fee or easements o which we now hold 80.

I will submit my statement for the record, Mr. Chairman. I would like to confine my remarks to some of the issues raised this morning.

As I understand the purpose of H.R. 7318, it is basically trying t continue the direction that this committee took in 1976 when it se up a number of conservation purposes for which tax deductions would be allowed. However, some of the suggestions raised this morning b Treasury in my opinion would take the committee in exactly the opposite direction and I would like to point out what those are.

First, let me address the question of public benefit. As I understan the gist of some of the remarks made this morning, it is alleged that a public benefit may not occur in some or maybe many of the cases i which easements are given to nonprofit conservation organizations It is stated, for example, that the owner that gives the easement ma not do something different than he was going to do anyway with hi property. In short, he is having his cake and eating it, too, and th public is paying for this privilege. The Treasury Department ha made the statement that they cannot individually judge each of thes easements that comes in, that they don't have the ability to decid whether or not a true public benefit is being met. In short, they ar not sure whether or not the conservation purposes as designed by th Congress in the act are being met or that the nonprofit organization are competent enough to do our job in deciding whether an easemen is meritorious.

The chairman raised the question of the central flyway and how on goes about protecting this. I would like to use this as an example t follow my line of argument. You basically protect the central flywa by doing two things: You protect the habitat within that flyaway an you also manage the birds that are moving up and down the Centra States between Canada and points in the United States. The Fish and Wildlife Service has had a program for a long time to acquire wetland areas on farms throughout the Midwest to protect the habitat of thes birds where they come down to rest and feed during the migrator process.

I would submit to this committee that what a particular person want to do with his property has absolutely nothing to do with the issu of whether the existing resource is perpetually protected. Farme Jones may not drain his wetland and put it in soybeans this year o next because he is happy with his income level. But what about hi sons? What about his heirs? What about the people who get the property after him?

You have to ask the question, how do we go about protecting th resource in perpetuity, because you have a number of statutes on th books that say it is the mission of the United States to protect migratory birds. So, you place a perpetual restriction on the use of that wetland so it cannot be drained, so it cannot be polluted, in short so that the natural environmental system can be maintained and that is where the public benefit is met. I think that the committee was headed in this direction in 1976 when it said that natural environmental systems should be protected and easements should be allowed to protect these wetland environmental systems which preserve wildlife populations.

It has been suggested that maybe we ought to tighten up the definition of conservation purposes or that maybe we should allow access to easement areas in order for the public to benefit. In our opinion, allowing public access to the easement area would in effect kill the program. The whole theory of an easement is that it is used in cases where a private owner either cannot financially afford to, or does not want to, donate his property; he wants to keep the incidence of private ownership but he is willing to accept perpetual restrictions on his uses of the property. He in effect, Mr. Chairman, is giving up a legitimate interest in his property that can be valued and for which he is even entitled to a deduction under current law. We support this principle and we think it is a good thing and we would like to see the committee continue in that direction.

There is also sort of a hidden assumption in some of the remarks that have been made this morning that there is a huge drain of the public purse going on in this easement program. I just would like to point out to the committee that since 1976 the Nature Conservancy, which is as far as I know the laregst national, nonprofit holder of easements in the country, has taken only 80 easements totaling 92,000 acres ranging in size from 5 acres to 42,000 acres. The estimated value of these easement gifts was $10 million or approximately $2.2 million per year. Assuming a 60-percent tax bracket for the donors, the revenue loss is $1.3 million annually. I would suggest, Mr. Chairman, that this is not a huge loss that the country cannot bear in order to protect its fish, wildlife, and plant habitats.

In closing, I think there is a philosophical principle, Mr. Chairman, that has to be addressed here and it is the central point around which all of these other controversies are raging. Are the nonprofit organizations going to be allow to do business as nonprofit organizations and to do things that Government cannot do or cannot do as effectively, or are we going to have to be tied into some kind of elaborate process whereby the Government is going to get involved, such as approving every easement that is donated and so forth?

I would suggest that we can do our job more effectively in serving the public benefit by continuing to do what we are chartered to do as nonprofit conservation organizations. If the committee feels that the definition of "conservation purposes" should be altered to help clarify the situation, fine, but I would hope the committee would stand on record as supporting the nonprofit sector in the conservation business because we are proud of what we are doing, we are not trying to ripoff the taxpayer. If we did that, we would be susceptible to losing our nonprofit status. So we really have no incentive to go around cutting deals with landowners that don't really benefit the public.

That sums up my statement, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF WILLIAM J. CHANDLER, LEGISLATIVE REPRESENTATIVE, THE NATURE CONSERVANCY

The Nature Conservancy is a national conservation organization with a membership over 80,000. Our major purpose is to scientifically identify significant natural areas throughout the nation, and to protect these natural areas through direct acquisition of fee title or partial interests in land (including conservation easements).

We support strongly the principle that tax incentives for the donation of land for conservation purposes is a meritorious application of Federal tax power. Thus, we support the goal of H.R. 7318 to refine and strengthen existing laws to encourage gifts of land.

The Conservancy has taken 80 conservation easements since 1915. We expect the easement tool to be even more important in the future as we race to conserve the Nation's significant natural areas before they are irretrievably destroyed. Not all of these areas can be bought, nor should they be. The easement approach is a highly refined tool for use in a special type of situation where a land owner is not willing or financially able to give fee title to his land to a conservation agency seeking to protect a significant resource on his property. However, the public benefit of preserving the resource can be met if use restrictions are placed on the property and the owner retains overall control of his property. For many years, public and private nonprofit organizations have utilized this conservation method effectively and without major abuse.

The Tax Reform Act of 1976 placed a five year time limit on the deductibility of easements for conservation purposes which expires June 14, 1981. Given the established utility of easements and their wide application, the Conservancy believes it appropriate that the expiration date be permanently removed as provided in Section 2 of H.R. 7318. This would send a clear signal to potential donors as well as donee organizations that tax incentives for easements will be available in the future. Should any abuses in the program ever be demonstrated, Congress can act to correct these with appropriate amendments to the statutes.

The other major provision of H.R. 7318 of interest to the Conservancy is the allowance of a deduction for donations of land for conservation purposes where the owner retains his mineral interests. We believe the preservation of significant natural areas, especially in the Southeast would be stimulated by such a provision provided that access to the minerals is by drilling or deep shaft mining and not strip mining. The Conservancy has found that the speculative value of oil and gas rights has understandably made owners of land reluctant to give away their entire property interests. However, some are willing to make donations of their surface interests if such donations were deductible. This approach provides double benefits to public policy: important natural areas are permanently conserved, and at the same time, potential energy supplies are not withdrawn from the market place.

In conclusion, I urge the Subcommittee to act favorably on H.R. 7318. It will clarify and strengthen existing tax incentives for donations of land. Concurrently, the legislation also contains supplementary provisions which will ensure that donations are made to qualified organizations exclusively for conservation purposes.

Mr. ROSTENKOWSKI. Ms. Gerard?

STATEMENT OF JENNIE GERARD, DIRECTOR, LAND TRUST PROGRAM OF THE TRUST FOR PUBLIC LAND

Ms. GERARD. Mr. Chairman and gentlemen of the subcommittee I am Jennie Gerard, director of the land trust program of the Trust for Public Land, a national conservation organization headquartered in San Francisco, Calif.

I appear before you today to support the bill H.R. 7318 with two suggestions for improvements which speak to some of the concerns raised this morning, and would prevent what can be a step backward by discontinuing tax incentives for important conservation matters

First, let me introduce the Trust for Public Land. We acquire interest in real property, in our own right, for eventual conveyance to public agencies for recreation purposes. We also assist community groups throughout the country to set up local land trusts, their own 501(c)(3) organizations, to acquire interest in property for community benefit.

The organizations that we have assisted range from countywide land trusts such as in Mesa County, Colo., where Grand Junction is located, to ones in Oakland and the more deteriorated urban centers of the United States such as the South Bronx. In all of these cases, the use of property for public benefit is an issue, including urban areas. Let me mention that one of the groups we are helping in northern California has acquired scenic easements over fragile bluff land that the State of California was strongly in favor of acquiring for a State park. As you see, quite often, the specific concerns of a conservation organization, or a governmental agency, can be met through partial interest, rather than total interest in real property.

We are pleased that H.R. 7318 does not succumb to the fallacy of equating public access with public benefit. Naturally, when it comes to recreational lands, they are useless without public access, but we are not talking exclusively about recreational lands. There are many other kinds to which public access would be inconsistent with the public benefit served by a gift of an open space easement over the land. I am concerned that that point not be lost on the subcommittee.

There are two major deficiencies of H.R. 7318, in our view. I would like to speak to those. The first is that the bill does not explicitly include the full range of open space preservation activities within the definition of "conservation purposes" over which it has been the practice of our organization to take open space easements. As a matter of fact, some of the major and most successful conservation programs in the country are taking open space easements. Those are easements that protect the public interest in the land, yet easements over these lands would not necessarily fall under the definition of the conservation purpose. Since open space easements are an important provision of the 1969 Tax Reform Act we are very concerned that the Treasury Department will interpret passage of this bill, as it reads today, as instruction from Congress not to preserve the open space easement features that are currently in practice. In other words, the deductibility of open space easements in perpetuity is an essential feature of tax law, one that many of us are operating under and are eager to see continued.

The second deficiency occurs in the definition of conservation organizations suitable for receipt of conservation easements. The definition does not include 509(a)(3) organizations. We have heard some discussion about 509(a)(3) organizations that would support public charities. Indeed these should be included but the definition also should include ones that support public agencies, too. These are park and recreation foundations, which support public agencies from the local level to the national level, that support governmental policy, that are organizations operating in lower profile to carry out the intent of public agencies. These, too, should be acceptable 509(a)(3) organizations and are important to be allowed to continue to accep conservation easements as they have done for some years.

With those two deficiencies corrected, namely, including the ope space easement provisions that we made explicit through the 1969 Ta Reform Act and including 509(a)(3) satellite organizations not onl supporting 501(c)(3) organizations but also public agencies—wit the correction of those two deficiencies we offer our unqualified support for H.R. 7318. I wish to thank your subcommittee and you staff's work for their efforts to prepare a bill to carry on what i strongly in the interests of the public and is the pursuit of organizations such as the Trust for Public Land.

[The prepared statement follows:]

STATEMENT OF JENNIE GERARD, ON BEHALF OF THE TRUST FOR PUBLIC LAN

I am here on behalf of The Trust for Public Land to express support for H.R 7318 while suggesting specific remedies for what we regard to be two deficiencie in the bill.

The Trust for Public Land (TPL) is a national land conservation organiz tion based in San Francisco which not only acquires land and interests in lan in its own right for eventual conveyance to public agencies at all levels of gover ment but also works with and assists dozens of local land trusts in communi ties as diverse as Mesa County, Colorado and the Lower East Side of Ma hattan Island.

These community land trusts, fashioned after groups with long and disti guished histories such as the Trustees of Reservations in Massachusetts, a models of local community control and protection of land resources. They a working well. As public agency land acquisition and maintenance budge shrink, community land trusts are a significant response to the times.

One group with which we work in Northern California has secured and no maintains easements over miles of fragile coastal bluffs in an area which th State had once felt it would be necessary to acquire and maintain itself in orde to protect. Another group in Central California has, by selective acquisition guaranteed the realization of an environmentally sensitive land use plan whic would not have been possible by exercise of the government police power alon And in some of our most seriously deteriorated urban centers in the Bron and Newark and Oakland, California, the acquisition of land and easements f mini-parks and gardens by block association land trusts has been the sprin board for neighborhood revitalization you can see and touch.

The needs of such land trusts and other conservation groups, as well as gover ment land acquisition agencies, are often quite specific and in many instanc the acquisition of a partial interest in real property will suffice to protect t resource threatened or provide the amenity sought. It is therefore importa as a matter of tax and conservation policy to provide for the deductibility donations of partial interests in real property for open space and other conserv tion purposes. It is for this reason that TPL strongly supports H.R. 7318.

We are pleased that H.R. 7318 does not succumb to the fallacy of equati public access with public benefit. Recreational lands are useless without publ access. But other land and historic resources which it is in the public intere to conserve can be destroyed without limitation and in many cases prohibiti of public access. Public access also increases maintenance costs. The whole poi of acquisitions of partial interests in real property such as conservation eas ments is that they are selective cost-effective tools. The public, through gover ment agencies and nonprofit organizations can acquire what it needs to provi an amenity or protect a threatened resource, but no more. And the public sav the cost of maintenance and stewardship which is often better left in priva hands.

To allow the deductibility of conservation easements to pass from the t law, as would be the consequence of a failure to enact H.R. 7318, would severe undercut successful, economic land conservation efforts across the country. Si ilarly, opportunities are being lost today to protect vital lands and habit because of the non-deductibility of donations of lands where subsurface miner rights are retained by the donor. H.R. 7318 would remedy this.

TPL views H.R. 7318 as a sound amendment to the law permitting the deductibility of contributions of partial interests in real property. Where there is a sunset date on the deductibility of conservation easements presently, the bill removes it, making the deductibility of such easements an ongoing feature of the law. While a donor of real property for conservation purposes may not presently claim a deduction if that donor retains subsurface mineral rights, the bill would allow the deduction. These are needed changes in the tax law.

Nonetheless there are two notable deficiencies in H.R. 7318: (1) It does not explicitly include the full range of open space preservation activities within the definition of "conservation purposes," and (2) it may inadvertently exclude many worthy park and conservation foundations from its definition of a "qualified organization."

Many of the more successful land preservation transactions over the past 10 years have proceeded under the so-called "undivided interest exception" and specifically Section 1.170 A-7 of the Internal Revenue Service Regulations. These regulations, reflecting Congressional intent as expressed in hearings on the 1969 Tax Reform Act, allow for the deductibility of "open space easements in gross in perpetuity."

What concerns us is the widely held assumption that the Treasury Department will view the bill before you as it finally passes as the definitive statement of the Congress on the deductibility of donations of partial interests in real property for open space and other conservation purposes and that Section 1.170 A-7 of the Regulations will be deleted. If this is the case, land conservation interests will have taken a giant step forward and an equally giant step backward. TPL believes the Congress should make clear to the Treasury its intent to continue to encourage the conservation of open space land through the tax law.

There are two ways in which this might be done—either one of which is endorsed by The Trust for Public Land. Our preferred method would be to add a qualified fourth "open space" category to the definition of "conservation purposes" in Section 170(f)(3)(C) of the Internal Revenue Code to read as follows: "(iv) the protection of land resources including aquifers, wetlands, flood hazard areas, shorelands, barrier islands, farmlands and forest lands, where conservation is in furtherance of a defined governmental policy." This amendment would, when read with the other interests already listed in the definition of conservation purposes, specifically identify the full range of land resources which it is in the nation's interest to conserve.

As an alternative, if your Subcommittee believes it is unnecessary to amend the definition of conservation purposes, we would request language in a committee report of the Congress which makes it clear to Treasury and all persons interested that H.R. 7318 is not intended to eliminate the "undivided interest exception" and that the donation of an open space easement in gross in perpetuity should remain deductible. Without, at a minimum, a clear statement of Congressional intent, we believe many successful open space easement programs will be seriously undermined.

Our second concern with H.R. 7318 is quite specific. As written the bill does not include Internal Revenue Code Section 509(a)(3) supporting organizations within the definition of "qualified organizations." Many public park agencies in cities and counties and states across the country have adjunct foundations which have been established to support a particular park or park system. These foundations, many of which have been in existence for many years, frequently hold title to real property and perform other support functions which the agencies are structurally unable to perform for themselves. We suspect that many, if not most of these foundations, are described in Section 509(a)(3) of the Internal Revenue Code and that their work would be seriously hampered by the passage of H.R. 7318 in its present form. We recommend that 509(a)(3) organizations be included within the definition of "qualified organizations" in H.R. 7318.

We would like to acknowledge and commend the efforts of Congressman Dingell and his staff and the efforts of the Subcommittee and its staff on H.R. 7318 and its predecessor H.R. 4611, and we thank you for this opportunity to be heard on both our concerns and support for H.R. 7318.

Mr. ROSTENKOWSKI. Thank you, Ms. Gerard.

Mr. Stark?

Mr. STARK. Mr. Chairman, I want to thank the panel again for taking the time to come here. I have had some concerns about the bill. I think my concerns are certainly not with the organizations represe ative here today, many of which have employees and trustees w whom I am acquainted and I am acquainted with the good works tl have done all over the country.

I think there have been some abuses in the donation of property charitable institutions, mostly in overevaluation. I think there h been some cases where eager tax advisers have been able to creat benefit for donors far beyond what they might ever get in an act sale. While obviously good causes such as yours benefit someti the taxpayers end up paying a little more than they might have to p for this same property if it were not for very optimistic apprais particularly in those areas where it is partial gift and partial ca

I am not sure that H.R. 7318 does anything one way or the ot to change that.

I also want to say—because I am sure that some of you do this your own expense and your own time—how important it is that y are here. The lack of attendance here is not due to our lack of inte in this, it is just that many of us are trying to cover two or three he ings at the same time. I had urged some of your organizations to s witnesses rather than just submit testimony in writing and I am s that the chairman and my colleagues on the committee would ag that when people such as yourselves take the time to come here testify it makes an impression and I appreciate the effort.

Thank you.

Mr. Rostenkowski. Thank you, Mr. Stark.

Were the subcommittee to decide that open space and farml should be preserved under the conservation purposes provision of code, how could the Federal Government assure that all charit contributions of open space and farmland easements provide a b fit to the public and not merely to the donor? If Federal dollars going to be spent to preserve open space and farmland, shouldn't t the Federal Government have a means to control how those dol are going to be spent? Would you like to comment on that?

Ms. Gerard. Yes, sir, I would like to comment on that. In a sug tion that we have made to the subcommittee staff, we propose an a tion to the conservation purposes definition that would specific itemize the types of open space over which it would be suitabl convey easements. As long as the conveyance of the partial inte is in furtherance of governmental policy. Now that does not m that the land over which the easement has been given must be nex a national park. It could be in furtherance of a State or local gov ment's policy to convey a conservation easement. This is a reason step toward assuring that there is public interest served and be obtained through the gift of the easement.

Mr. Rostenkowski. You don't find it a hardship that the Gov ment that is going to make the contribution toward the preserva of that land had something to say about it?

Ms. Gerard. This is not a harsh feature.

Mr. Coughlin. Could I supplement Ms. Gerard's answer to question?

Mr. Rostenkowski. Yes.

Mr. Coughlin. The Internal Revenue Service has recently re nized for income tax exemption purposes a farmland conserva trust where the conservation program was in furtherance of a defined governmental purpose, in that case at the State level. So there is some precedent from the IRS standpoint to treat open space preservation, at least where it is in furtherance of a local governmental policy, as being consistent with these charitable purposes for which tax exemption may be granted. Also, Congress in 1976 recognized farmland conservation as being, to some extent in furtherance of a governmental purpose by recognizing alternate valuation for family farms. I think the concept underlying charitable contributions for open space easements, of a shift of the speculative value represented by the development rights being given away in the easement, is very comparable to the 1976 alternate valuation provisions that were written into the tax code.

Mr. **Rostenkowski**. When you determine that an easement which you have acquired no longer serves the conservation purposes for which it was contributed, how do you handle that?

Mr. **Coughlin**. Mr. Chairman, at common law if the easement no longer serves its purposes I think under State common law governing easements, it might be extinguished. That is the substantive real property consequences. Take for example, a national historic landmark, that burns. The purpose for imposing the preservation easement was to protect that landmark property. If that purpose can no longer be achieved, then I believe the easement could be extinguished. Now an easement could be drafted to expressly reserve prior approval over replacement structures which the national trust has done on occasion where it was in furtherance of a very specific purpose. Alternatively prior approval of the organization could be required to extinguish the easement.

In terms of the income tax consequences, I don't have a complete answer. In part when a gift of an easement is imposed, the taxpayer's basis in the property is reduced by the value of the easements the difference between the fair market value of the property unrestricted and as restricted by the easement. Presumably at a future point if that restriction is released, the market value would again return to its unrestricted market value. Under the tax-benefit concept that could be treated as a recapture, possibly. More properly, if the property were sold the increased value would be recognized and taxed as result of an increased capital gains tax obligation. So the revenue loss is not complete as a result of the charitable gift of an easement which, because of changed circumstances, may later be released.

Mr. **Rostenkowski**. How does your organization enforce these?

Mr. **Coughlin**. In several ways, sir. Initially all easements held by the trust are subject to inspection. If there is a violation of an easement, which has not occurred to date, then we have full legal rights to go in and compel restoration of the structure to its configuration prior to alteration. Alternatively we are entitled to monetary damages. Also, to a degree open space easements are self-enforcing because lenders will not lend money to develop land in violation of a recorded easement.

Mr. **Chandler**. Mr. Chairman, also we have to go around and make sure that the easements we hold are being obeyed by the private owner and that nothing is occurring that is prohibited in the easement document. We have a regular monitoring program to make those inspections and as Mr. Coughlin pointed out our remedy is to go to court t prevent things from happening or to get damage and restoration costs.

Mr. Rostenkowski. If you have problems?

Mr. Chandler. Yes; if we have problems. We can take the owner to court and take that route and we are not hesitant to do so.

Mr. Rostenkowski. Again the Secretary of the Interior has expressed the view that an easement over wetlands on a farm located in the central flyway for migratory fowl would serve a public interest whether or not there is public access to the land. Would you be kind enough to tell me how much land the central flyway covers?

Mr. Chandler. I cannot give you the specific acreage, Mr. Chairman, but we are basically talking about the Central States over which ducks—migratory birds, geese, and so forth—pass in coming down to their wintering habitats on the southeast coast and in the Texas area. The full acreage is probably very large over which they fly. This flyway has been studied a long time by the Fish and Wildlife Service and I am sure they could give this subcommittee an idea of what it covers. They know which wetlands the ducks are using or would potentially use. To date Interior has already acquired about 1 million acres of easements in the central flyway area.

Mr. Rostenkowski. How many millions of acres are there?

Mr. Chandler. I am talking about the wetland acres. There are many more millions of acres within the flyway but they only try to protect wetland acreage on these farms with easements.

Mr. Rostenkowski. Do you think the Government should pay for all these over the flyway?

Mr. Chandler. I believe if we are to preserve the Nation's wildlife that we do have to take actions to see that that is done and the Fish and Wildlife Service has determined that it is less costly to acquire easements than acquiring in fee the wetlands. There are a number of private organizations that try to get donations such as Ducks Unlimited and so forth.

Mr. Rostenkowski. Are there any other questions of the witnesses? If not, thank you very much.

Mr. Chandler. Thank you.

Mr. Rostenkowski. Mr. Emory, Mr. Miller, Mr. Van Auken, and Mr. Morris.

Welcome to the committee, gentlemen. We will accept your testimony in the order in which I called your names. If Mr. Emory would start off followed by Mr. Miller, Mr. Van Auken, and then Mr. Morris.

STATEMENT OF BENJAMIN R. EMORY, ON BEHALF OF THE MAINE COAST HERITAGE TRUST, THE TRUSTEES OF RESERVATIONS, AND THE SOCIETY FOR THE PROTECTION OF NEW HAMPSHIRE FORESTS

Mr. Emory. Mr. Chairman, members of the subcommittee, I am Benjamin R. Emory, executive director of Maine Coast Heritage Trust. We are a nonprofit organization created 10 years ago specifically to encourage the use of conservation easements to preserve the scenic, ecological, and cultural values of the Maine coast. We have helped arrange 170 conservation easements conserving about 13,000 acres. Of these 92 are held by the Federal Government through Acadia National Park.

I also am representing today two other New England organizations. One is the Trustees of Reservations which was founded in 1891 to preserve "beautiful and historic places and tracts of land" in Massachusetts. The Trustees of Reservations holds 52 conservation easements preserving nearly 5,000 acres. The other organization is the Society for the Protection of New Hampshire Forests which was established in 1901 to conserve New Hampshire's natural resources. The society holds and has helped other agencies acquire 35 conservation easements protecting over 7,000 acres.

We three organizations feel compelled to oppose H.R. 7318 in its present form. We recognize that it reflects careful thought and hard work by many people committed to and experienced in land conservation. Without revisions, however, we believe an unintended effect of H.R. 7318 will be to cut back materially the availability of Federal tax incentives which have been important to our work and to the public interest over the past decade.

We will support H.R. 7318 wholeheartedly if two critical adjustments are made:

First: We believe that organizations qualified to accept conservation easements should include support organizations within the meaning of section 509(a)(3) of the code. The Trustees of Reservations has had such a support organization operating successfully since 1973. Titled the Massachusetts Farm and Conservation Lands Trust, it was created to accept unusual gifts of land and conservation easements that do not necessarily fit the standards of museum quality with which the Trustees of Reservations judges its landscape acquisitions. Without this revision, passage of H.R. 7318 will curtain the continuing work of this support organization.

Second: The proposed legislation introduces into our programs a new limitation—the so-called conservation purposes test. It could materially restrict and jeopardize the success of our programs, for it is an unduly narrow definition of conservation purposes.

For example, the Society for the Protection of New Hampshire Forests actively promotes conservation easements as a way to further the preservation and sound management of productive woodlots. The conservation and management of woodlots, essential to the fiber and energy requirements of our Nation, do not fit clearly within the definition of conservation purposes.

We at Maine Coast Heritage Trust have negotiated conservation easements preserving islands and outstanding portions of the mainland. A recent mainland easement protects an operating farm in a rapidly growing town. The easement helps maintain the open space and rural character of the community, a matter of great local concern. We do not believe that the conservation purposes test is adequately clear as to the deductibility of the value of such an easement.

It is important to recognize that a landowner's willingness to make a gift usually depends on clarity of the statute rather than opinion of counsel or resort to the Internal Revenue Service's rulings process. Congress should state clearly by statute the types of conservation easements qualifying for tax deductions. Clarifying the conservation purposes test to include forest land, farmland and open space will satisfy our concern and meet what we believe are major resource needs of our Nation.

Our suggested revisions are, we believe, wholly in furtherance of the purposes of the law as we have known it since the Tax Reform Act of 1969 and subsequent regulations and rulings of the Treasury Department. We very much hope these revisions will be made to avoid curtailing our programs. With the revisions H.R. 7318 will have our full support.

I would like to take 1 more minute to address the public access issue which has been raised today. Very, very few landowners would be willing to grant conservation easements if they had to provide for public access of the 170 easements that we have helped to arrange in Maine. A couple of examples of easements provides for public access. Let me mention only one which illustrates public benefit other than public access and other than scenic enjoyment. These examples were provided to Mr. Halperin a couple months ago.

The Bureau of Parks and Recreation, a Maine State agency, and the town of Gray each hold conservation easements on woodlots. Several agencies also hold easements on operating farms. There is great concern in Maine, particularly because of spiraling energy costs, that we do what we can to preserve our wood resources and for agricultural production. Firewood is increasingly a necessity for us and importing food into Maine is very costly.

In another example, last winter the town of Southwest Harbor in a rapidly growing section of town accepted an easement. It did so to help preserve the character of that section of town and because it recognizes the development often costs a town more in services than it returns in increased revenues.

Thank you very much for the opportunity to testify.

[The following was subsequently received:]

MAINE COAST HERITAGE TRUST,
Northeast Harbor, Maine, June 30, 1980.

Hon. DAN ROSTENKOWSKI,
Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, Washington, D.C.

DEAR MR. ROSTENKOWSKI: I very much appreciated the opportunity to testify at the June 26, 1980, hearing on H.R. 7318. In this letter I wish to comment on the three basic issues raised by the Treasury Department—public benefit, private gain and little private cost, and inaccurate valuation. My thoughts on these issues are based on our experience here in Maine, where Maine Coast Heritage Trust has helped arrange 170 conservation easements preserving about 13,000 acres of land. These easements are held by both government agencies and public charities.

How is the Federal Government to ensure that conservation easements are indeed providing a public benefit?

I believe that sufficient safeguards already exist to ensure that conservation easements serve a public benefit. In the case of easements to governmental bodies—federal, state, and local—such an easement cannot be put into effect unless the governmental grantee agrees to accept the easement. Thus public officials review all easements offered to governmental bodies, and in Maine we have seen a number of such easements declined when there seemed insufficient public benefit.

Public officials usually do not review offers of conservation easements to public charities. However, neither do public officials review offers to public charities of gifts of title to land—nor, for that matter, of gifts of securities, cash, yachts, or other items of value.

A public charity only accepts gifts that further its purposes in some way. Those purposes have already been approved by the Internal Revenue Service as the justification for the organization's tax-exempt status. There is no more reason for public officials to endorse the public benefit of each and every offer of a conservation easement to a public charity than there is for public officials to ensure that every cash gift and every gift of title to land is being used to benefit the public.

Furthermore, public charities are going to be particularly careful to ensure that conservation easements, as opposed to other types of gifts, further their corporate purposes. Conservation easements impose long-term monitoring and enforcement burdens on the recipient, and unlike other assets they lack the advantage of being readily convertible to cash.

Should the donor of a conservation easement receive tax benefits for giving away development restrictions on which he has no plans to capitalize?

What the donor might or might not have done with the development rights in the absence of the conservation easement should be immaterial. The fact is that he has given away a capital asset, the development rights. He no longer can enjoy those development rights in any way. Clearly, this is different from Treasury's example of a remainder interest in art. The art piece may remain in the owner's possession until death, but the development rights are gone from the owner's possession as soon as he conveys the conservation easement. Treasury in its argument, is failing to distinguish between the development rights given away and the fee interest which the landowner continues to hold in the property.

How can aggressive valuations be policed?

I agree that appraising a gift of a conservation easement may be somewhat more complex and subjective than appraising a gift of title in those situations where there is no data on sales of comparably restricted properties. The explosion of land use laws and ordinances, however, has given appraisers ever increasing experience in appraising restricted properties, and, of course, there are ever more sales of restricted properties to which appraisers can refer. Thus to the extent that appraising conservation easements may present difficulties, those difficulties are steadily being alleviated. They cannot be considered as making aggressive valuations significantly more of a problem than aggressive valuations in other types of charitable gift appraisals.

Our experience in Maine indicates no reason to make the Tax Code as it affects the deductibility of gifts of conservation easements less liberal than it has been since 1969. Doing so could jeopardize our on-going conservation easement program.

Sincerely,

BENJAMIN R. EMORY,
Executive Director.

Mr. ROSTENKOWSKI. Thank you, Mr. Emory.

Mr. Miller?

STATEMENT OF DAVID P. MILLER, ON BEHALF OF THE MARYLAND ENVIRONMENTAL TRUST, THE MARYLAND HISTORICAL TRUST, THE MARYLAND AGRICULTURAL LAND PRESERVATION FOUNDATION, AND THE MARYLAND DEPARTMENT OF NATURAL RESOURCES

Mr. MILLER. Mr. Chairman, members of the subcommittee, I am David P. Miller, executive director of the Maryland Environmental Trust, and I also am speaking for the Maryland Historical Trust, the Maryland Agricultural Land Preservation Foundation, and the Maryland Department of Natural Resources.

These four agencies of State government support H.R. 7318 if it is amended to assure the eligibility of certain private organizations and to prescribe a definition of conservation purposes which suits the needs of public and private conservation groups. Others will speak to the former point, but a description of Maryland's four land preservation programs will show you the importance of this type of tax provision to longstanding and continuing conservation programs.

First: With its objective of setting aside 10 percent of Maryland's land area for public recreational use, program open space, an activity of State and local government, has spent an average of $20 million per year for the past 11 years. The State now has 296,000 acres and the local governments 93,535 acres. To meet their ultimate objective they must purchase an additional 243,000 acres.

Second: To preserve farmland from development the Maryland Agricultural Land Preservation Foundation is helping to form agricultural districts and is purchasing easements from farmland owners; by July the foundation will have formed 13 agricultural districts composed of 150 farms and 26,000 acres of farmland. To date the foundation has purchased 14 easements on 2,500 acres at an average price of $950 per acre.

Third: The Maryland Historical Trust holds 114 preservation easements restricting 5,279 acres. Eighty-one of these easements, covering 612 acres, are the result of payments in the form of grants, loans or fees. In contract, 33 easements, restricting 4,667 acres, were the result of donations to the Maryland Historical Trust.

Fourth, The Maryland Environmental Trust, of which I am the director, has been given 40 conservation easements on 9,523 acres, of which 5,501 acres are farmland and 3,042 acres are forest land. [Four easements are joint agreements with the historical trust.] By the end of this year we expect to complete 20 conservation easements on 8,000 acres.

The donation of conservation easements to these two trusts has preserved 12,336 acres of historic sites, farmland, forest land and natural areas in Maryland without significant acquisition or management costs.

Clearly, we cannot protect and preserve the agricultural, ecological and cultural values of Maryland's landscape entirely by purchases of land and development rights. It is essential to the success of these four complementary programs that the Federal law permit a charitable deduction for the donation of conservation easements.

Also, it is essential that open space, farmland and forest land be included in any definition of conservation purposes. We suggest the following prototype in making a definition of conservation purposes:

A. The preservation of land areas for outdoor recreation, education or scenic enjoyment by the public;

B. The preservation of historically important land areas or structures;

C. The protection of natural environmental systems;

D. The preservation of open space, farmland or forestland where such preservation is in furtherance of a local, state or national policy.

We feel that with such a definition a new law will continue to support the existing conservation programs of private and public organizations.

If you don't mind, I would like to ad lib since you have shown an interest in how we enforce these easements and to explain briefly what we do when we consider an easement. Our concern for enforcement starts when we begin to discuss the easement with the owner because the main thing we have to be reasonably assured of is that the easement will work. In a State like Maryland where urbanization is happening very fast it would be easy to take an easement on an area that would be nullified by the effect of changes in the land use in the surrounding area. It would become an island of farmland in the midst of suburban development which would make life intolerable for the person trying to farm the land.

So, one of the things we try to do is see if the proposed easement is workable; that is, in the long run are the planning and zoning, land-use trends, and other public considerations in that particular area conducive to the success of the easement. We don't accept an easement unless we feel we have a reasonable chance of making it work over a long period of time.

Now the other aspect of it is that once we have the easement we visit our easement sites at least once a year and we tend to be in frequent contact with the owners of our easement land because we are trying to develop enthusiasm for conservation easements with their neighbors. We are beginning to get concentrations of easements because the action of one landowner in an area, that we are particularly interested in, results in an adjacent or nearby owner doing the same thing. There are several examples that I could give if they would be useful to you.

In the case of public access, I agree that we would not be accepting a very large number of easements if public access were required. It is similar, I think, in your situation if you gave an easement on your home, whether preservation or conservation easement. If public access were required, how would you want to do it? Would you like every user to knock on your front door and say, "I am here and I am going to be using the land for a little while," or would you rather go into the recreation business where you say, "Well, no, you don't have to knock on my door, I will just deal with the public access problems as they come along." If public access is necessary, it seems to me you can't manage a conservation easement with it because the effect on the land itself, not to mention on other land uses like farming, is intolerable so you might as well spend the money to buy the property in fee.

In closing I would like to say that the Treasury Department's testimony makes frequent reference to what they call aggressive valuations. They keep saying there "may be" aggressive valuations. I don't think they have yet said "there are"—Mr. Stark came the closest when he said he thinks there are aggressive valuations. I would be willing to bet that the Treasury Department does not even know how many easements there are and does not know what the tax effects of those deductions have been.

Although we do not get into appraisals, I have heard some of our donors talk about their appraisals and they have shown me some of their appraisals and if anything those appraisers are being overly cautious, it seems to me, because they know the chilling effect that an IRS challenge can have on a landowner, on any landowner regardless of income.

I will be glad to answer questions if you would like me to.

[The following was subsequently received:]

MARYLAND AGRICULTURAL LAND PRESERVATION FOUNDATION,
Annapolis, Md., June 20, 1980.

SUBCOMMITTEE ON SELECT REVENUE MEASURES OF WAYS AND MEANS,
U.S. House of Representatives, Longworth House Office Building,
Washington, D.C.

SIRS: The Maryland Agricultural Land Preservation Foundation requests your approval of the subject bill with clarifications. Continued tax deductibility for donations of conservation easements relative to open space and productive farmland and forestlands is of the utmost importance in implementing Maryland policy and programs.

The Maryland Agricultural Land Preservation program includes provisions for voluntary districting, easement purchase, and easement donation relative to qualified, productive agricultural land and woodland. With respect to the latter provision, both Federal and State taxation incentives are imperative to achieve public objectives.

Both the Maryland Environmental Trust and the Maryland Historical Trust easement programs also are dependent upon Federal tax deductibility to succeed.

It is in these respects that Maryland policy and programs are dependent upon your affirmative action today.

The proposed bill, however, does not specifically express eligibility of farmland or forestland, either through legislative intent or eligibility definitions. We trust that your judgment and action will be such to insure eligibility of these lands to avoid regulatory implementation of the law to the contrary.

Thank you for the opportunity to comment.

Sincerely,

ALAN R. MUSSELMAN,
Executive Director.

Mr. ROSTENKOWSKI. Thank you, Mr. Miller.

Mr. Van Auken?

STATEMENT OF TYSON B. VAN AUKEN, DIRECTOR, VIRGINIA OUTDOORS FOUNDATION, COMMONWEALTH OF VIRGINIA

Mr. VAN AUKEN. Thank you, Mr. Chairman.

My name is Tyson B. Van Auken and I am the executive director of the Virginia Outdoors Foundation.

I have submitted a written statement which I would like to highlight very briefly.

The foundation is an agency of the Commonwealth of Virginia. It was created by the State in 1966 to acquire open space by means of private philanthropy. The foundation exists to preserve the natural, scenic, historic, scientific, and recreational areas of the State in the public interest. Since 1966 we have acquired 127 open space easements, all of which have been donated to the foundation covering 21,000 acres of land. Our sister agency, the Virginia Historical Commission, has had 77 easements donated to them to protect registered historical landmarks and their settings.

This program is carried out in conjunction with the statute and in conjunction with land use plans in the localities. We really have no quarrel with H.R. 7318 and think it is a good bill if it can be amended to specifically define conservation purpose as including open space preservation.

I would be happy to answer any questions you may have.

[The prepared statement follows:]

STATEMENT OF TYSON B. VAN AUKEN, ON BEHALF OF THE VIRGINIA OUTDOORS FOUNDATION, COMMONWEALTH OF VIRGINIA

My name is Tyson B. Van Auken and I am the Executive Director of the Virginia Outdoors Foundation. The Foundation is an agency of the Commonwealth of Virginia. It was created by the State in 1966 to acquire open space by means of private philanthropy. The Foundation exists to preserve the natural, scenic, historic, scientific, and recreational areas of the State. It is the public policy of Virginia that open space lands be preserved. A copy of the law is attached to the back of this statement.

In addition to creating the Foundation, the 1966 Virginia General Assembly passed the "Open Space Land Act." This law authorizes public bodies to acquire open space to curb rapid growth and urbanization in areas that should be preserved in the public interest. The acquisition may be in fee or by easement. For the purpose of the Open Space Land Act "open-space land" means land which is provided or preserved for (1) park or recreational purposes, (2) conservation of land or other natural resources, (3) historic or scenic purposes, (4) assisting in the shaping of the character, direction, and timing of community development, or (5) wetlands. The act also encourages that open space land, where appropriate, continue in agricultural production. A copy of the law is attached to this statement.

Since 1966, the Virginia Outdoors Foundation has acquired 127 open space or conservation easements that protect 21,000 acres of land. Over 3,000 acres in fee holdings have also been acquired. Every easement and every fee parcel have been donated to the Foundation by generous, public-minded citizens of the Commonwealth. Our sister agency, The Virginia Historic Landmarks Commission, has acquired 77 easements to protect Registered Historic Landmarks and their settings. All of the historic easements were donated. These easements protect many kinds of resources including farmland, Chesapeake Bay frontage, the home of William Byrd of Westover, mountain land, land bordering Shenandoah National Park, land along designated State Scenic Rivers and Highways, critical environmental areas, and other lands of local, State, and national significance.

The Commonwealth of Virginia would urge the Subcommittee to give serious consideration to the public benefit derived from the open space preservation program in our State. Favorable federal tax legislation that would make certain the deductibility for federal tax purposes of open space easements is essential for the continuation of our efforts to use private philanthropy to achieve public conservation goals. To that end, we would ask that the Subcommittee look favorably upon defining "Conservation Purpose" in H.R. 7318 and to include something similar to the following definitions in the conservation purpose amendment to the bill:

(1) Preservation of land areas for outdoor recreation, education or scenic enjoyment by the public.

(2) Preservation of historically important land areas or structures.

(3) Protection of natural environmental systems or plant or animal habitat where such systems or habitat are of local, regional, state, or national significance.

4. Preservation of open space, farmland, or forest land where such preservation furthers local, state, or national policy.

Thank you for your kind attention. I would be pleased to answer any questions the Subcommittee may have.

Virginia Outdoors Foundation

Section
10–159. Declaration of policy.
10–160. Foundation created.
10–161. Administration of Foundation; appointment, terms, oath, etc., of board of trustees.
10–162. Chairman of board; quorum.
10–163. General powers of Foundation.
10–164. Annual report.
10–165. Gifts, devises and bequests.
10–166. Cooperation of State agencies, etc.

SECTION 10–159. DECLARATION OF POLICY

It is hereby declared to be the public policy of Virginia that the preservation of open-space lands is in the public interest and is to be encouraged. (1966, c. 525.)

The numbers of §§ 10–159 to 10–166 were assigned by the Virginia Code Commission, the 1966 act having assigned no numbers.

Legislative findings. Section 1 of Acts 1966, c. 525, provides: "The General Assembly finds that the State's population is increasing rapidly and becoming concentrated in urban and suburban areas; that the open space available for parks as well as natural, scenic, historic, scientific and recreational areas is being diminished constantly and it is in the public interest that preservation of open space be encouraged."

SECTION 10–160. FOUNDATION CREATED

In order to promote the public policy above declared, and to encourage private gifts of money, securities, land, or other property of whatever character for the purpose of preserving that natural, scenic, historic, scientific, and recreational areas of the State, there is hereby created the Virginia Outdoors Foundation, a body politic to be organized and to have such powers as hereinafter provided. (1966, c. 525.)

SECTION 10–161. ADMINISTRATION OF FOUNDATION; APPOINTMENT, TERMS, OATH, ETC., OF BOARD OF TRUSTEES

The Virginia Outdoors Foundation shall be governed and administered by a board of trustees composed of the State Treasurer to serve ex officio, and six trustees from the State at large to be appointed by th Governor. Initially the trustees-at-large shall be appointed for the following terms: two for a term of four years, two for a term of three years, and one for a term of two years. The sixth trustee-at-large shall be appointed initially for a term of two years. Thereafter, successors to trustees-at-large whose terms expire shall be appointed for terms of four years. Vacancies shall be filled for the unexpired term. No trustee-at-large shall be eligible to serve for more than two successive terms, but appointment to fill a vacancy shall not be considered as one of the two terms. All trustees-at-large shall take the oath of office as prescribed by law and post bond in the penalty of five thousand dollars with the State Comptroller prior to entering upon the functions of office. No compensation shall be paid to any trustee for his service, but each trustee shall be reimbursed for travel and expenses incurred by him in the performance of his duties on behalf of the Foundation. (1966, c. 525; 1970, c. 757.)

SECTION 10–162. CHAIRMAN OF BOARD; QUORUM

The Governor shall appoint a chairman of the board, from among the six trustees-at-large. A majority of the members of the board serving at any one time shall constitute a quorum for the transaction of business. (1966, c. 525; 1970, c. 757.)

SECTION 10–163. GENERAL POWERS OF FOUNDATION

To enable it to carry out its functions, the Virginia Outdoors Foundation shall have the following general powers:

(a) To have succession until dissolved by Act of Assembly, in which event title to the properties of the Foundation, both real and personal, shall, insofar as consistent with existing contractual obligations and subject to all other legally enforceable claims or demands by or against the Foundation, pass to and become vested in the Commonwealth of Virginia;

(b) To sue and be sued in contractual matters in its own name;

(c) To promulgate such rules and regulations, not inconsistent with the laws of the State, as it deems necessary for the administration of its functions under chapter 1.1 (§ 9–6.1 et. seq.), Title 9, of the Code of Virginia, including among other matters, administration of funds, and the organization and procedure of the board of trustees;

(d) To accept, hold, and administer gifts and bequests of money, securities, or other property of whatsoever character, absolutely or in trust, for the purposes for which the Foundation is created. Unless otherwise restricted by the terms of the gift or bequest, the Foundation is authorized to sell, exchange, or otherwise dispose of and to invest or reinvest in such investments as it may determine from time to time the moneys, securities, or other property given or bequeathed to it. The principal of such funds, together with the income therefrom and all other revenues received by it from any source whatsoever, shall be placed in such depositories as the Foundation shall determine and shall constitute a special fund and be subject to expenditure by the Foundation for its purposes without further appropriation. The Foundation shall not engage in any business except in the furtherance of its objectives;

(e) To acquire by gift, devise, purchase, or otherwise, absolutely or in trust, and to hold and, unless otherwise restricted by the terms of the gift or devise, to encumber, convey, or otherwise dispose of, any real property, or any estate or interest therein, as may be necessary and proper in carrying into effect the purposes of the Foundation;

(f) To enter into contracts generally and to execute all instruments necessary or appropriate to carry out its purposes;

(g) To appoint and prescribe the duties of such officers, agents, and employees as may be necessary to carry out its functions, and to fix and pay such compensation to them for their services as the Foundation may determine; and

(h) Generally to do any and all lawful acts necessary or appropriate to carry out the purposes for which the Foundation is created. (1966, c. 525.)

SECTION 10-164. ANNUAL REPORT

The Foundation shall, on or before the first day of November in each year, transmit to the Governor a report of its proceedings and activity for the preceding fiscal year, including a full and complete statement of its receipts and expenditures. (1966, c. 525.)

SECTION 10-165. GIFTS, DEVISES, AND BEQUESTS

Gifts, devises and bequests, whether personal or real property, and the income therefrom, accepted by the Foundation, shall be deemed to be gifts to the Commonwealth of Virginia, which shall be exempt from all State and local taxes, and shall be regarded as the property of the State for the purposes of all tax laws. (1966, c. 525.)

SECTION 10-166. COOPERATION OF STATE AGENCIES, ET CETERA

All State officers, agencies, commissions, departments, and institutions are directed to cooperate with, and assist, the Virginia Outdoors Foundation in carrying out its purpose, and to that end may accept any gift or conveyance of land or other property in the name of the Commonwealth from the Foundation. Such property shall be held in possession or used as provided in the terms of the trust, contract, or instrument by which it is conveyed. (1966, c. 525.)

Open-Space Land Act

Section

10-151. Title of chapter.
10-152. Authority of public bodies to acquire or designate property for use as open-space land.
10-153. Diversion of property from open-space land use; conveyance or lease of open-space land.
10-154. Further powers of public bodies.
10-155. Assessment of real property where interest less than fee is held by public body; exemption of interest of public body from taxation.
10-156. Definitions.
10-157. Chapter controlling over other laws; powers supplemental.
10-158. Acquisition of title subject to reservation of farming or timber rights; acquisition of easements, etc.; property to be made available for farming and timber uses.

SECTION 10-151. TITLE OF CHAPTER

This chapter shall be known and may be cited as the "Open-Space Land Act." (1966, c. 461.)

The numbers of §§ 10-151 to 10-158 were assigned by the Virginia Code Commission, the 1966 act having assigned no numbers.

Legislative findings; purpose of chapter.—Acts 1966, c. 461, § 2, provides: "The General Assembly finds that the rapid growth and spread of urban development are creating critical problems of service and finance for the State and local governments; that the present and future rapid population growth in urban areas is creating severe problems of urban and suburban living; that the provision and preservation of permanent open-space land are necessary to help curb urban sprawl, to prevent the spread of urban blight and deterioration, to encourage and assist more economic and desirable urban development, to help provide or preserve necessary park, recreational, historic and scenic areas, and to conserve land and other natural resources; that the acquisition or designation of interests and rights in real property by public bodies to provide or preserve permanent open-space land is essential to the solution of these problems, the accomplishment of these purposes, and the health and welfare of the citizens of the State; and that the exercise of authority to acquire or designate interests and rights in real property to provide or preserve permanent open-space land and the expenditure of public funds for these purposes would be for a public purpose.

"Pursuant to these findings, the General Assembly states that the purposes of this act are to authorize and enable public bodies, including as public bodies political subdivisions, to preserve permanent open-space land in urban areas (as herein defined) in order to assist in the solution of the problems and the attainment of the objectives stated in its findings."

SECTION 10–152. AUTHORITY OF PUBLIC BODIES TO ACQUIRE OR DESIGNATE PROPERTY FOR USE AS OPEN-SPACE LAND

To carry out the purposes of this chapter, any public body may (a) acquire by purchase, gift, devise, bequest, grant or otherwise title to or any interest or rights of not less than thirty years duration in real property that will provide a means for the preservation or provision of open-space land and (b) designate any real property in which it has an interest of not less than thirty years duration to be retained and used for the preservation and provision of open-space land. Any such interest may also be perpetual. The use of the real property for open-space land shall conform to the official comprehensive plan for the area in which the property is located. No property or interest therein shall be acquired by eminent domain by any public body for the purposes of this chapter, provided, however, this provision shall in no way limit the power of eminent domain as it was possessed by any public body prior to the passage of this chapter. (1966, c. 461; 1974, c. 259.)

SECTION 10–153. DIVERSION OF PROPERTY FROM OPEN-SPACE LAND USE; CONVEYANCE OR LEASE OF OPEN-SPACE LAND

(a) No open-space land, the title to or interest of right in which has been acquired under this chapter and which has been designated as open-space land under the authority of this chapter, shall be converted or diverted from open-space land use unless the conversion or diversion is determined by the public body to be (1) essential to the orderly development and growth of the urban areas, and (2) in accordance with the official comprehensive plan for the urban area in effect at the time of conversion or diversion. Other real property of at least equal fair market value and of as nearly as feasible equivalent usefulness and location for use as permanent open-space land shall be substituted within a reasonable period not exceeding one year for any real property converted or diverted from open-space land use, unless the public body should determine that such open-space land or its equivalent is no longer needed. The public body shall assure that the property substituted will be subject to the provisions of this chapter.

(b) A public body may convey or lease any real property it has acquired and which has been designated for the purposes of this chapter. The conveyance or lease shall be subject to contractual arrangements that will preserve the property as open-space land, unless the property is to be converted or diverted from open-space land use in accordance with the provisions of subsection (a) of this section. (1966, c. 461.)

SECTION 10–154. FURTHER POWERS OF PUBLIC BODIES

(a) A public body shall have all the powers necessary or convenient to carry out the purposes and provisions of this chapter, including the following powers in addition to others granted by this chapter:

(1) To borrow funds and make expenditures necessary to carry out the purposes of this chapter;

(2) To advance or accept advances of public funds;

(3) To apply for and accept and utilize grants and any other assistance from the federal government and any other public or private sources, to give such security as may be required and to enter into and carry out contracts or agreements in connection with the assistance, and to include in any contract for assist-

ance from the federal government such conditions imposed pursuant to federal laws as the public body may deem reasonable and appropriate and which are not inconsistent with the purposes of this chapter;

(4) To make and execute contracts and other instruments necessary or convenient to the exercise of its powers under this chapter;

(5) In connection with the real property acquired and designated for the purposes of this chapter, to provide or to arrange or contract for the provision, construction, maintenance, operation, or repair by any persons or agency, public or private, of services, privileges, works, streets, roads, public utilities or other facilities or structures that may be necessary to the provision, preservation, maintenance and management of the property as open-space land;

(6) To insure or provide for the insurance of any real or personal property or operations of the public body against any risks or hazards, including the power to pay premiums on the insurance;

(7) To demolish or dispose of any structures or facilities which may be detrimental to or inconsistent with the use of real property as open-space land; and

(8) To exercise any or all of its functions and powers under this chapter jointly or cooperatively with public bodies of one or more states, if they are so authorized by State law, and with one or more public bodies of this State, and to enter into agreements for joint or cooperative action.

(b) For the purposes of this chapter, the State or a city, town, or county may:

(1) Appropriate funds;

(2) Levy taxes and assessments;

(3) Issue and sell its general obligation bonds in the manner and within the limitations prescribed by the applicable laws of the State; and

(4) Exercise its powers under this chapter through a board or commission, or through such office or officers as its governing body by resolution determines or as the Governor determines in the case of the State. (1966, c. 461.)

SECTION 10–155. ASSESSMENT OF REAL PROPERTY WHERE INTEREST LESS THAN FEE IS HELD BY PUBLIC BODY; EXEMPTION OF INTEREST OF PUBLIC BODY FROM TAXATION

Where an interest in real property less than the fee is held by a public body for the purposes of this chapter, assessments made on the property for taxation shall reflect any change in the market value of the property which may result from the interest held by the public body. The value of the interest held by the public body shall be exempt from property taxation to the same extent as other property owned by the public body. (1966, c. 461.)

SECTION 10–156. DEFINITIONS

The following terms whenever used or referred to in this chapter shall have the following meanings unless a different meaning is clearly indicated by the context:

(a) "Public body" means any State agency having present authority to acquire land for a public use, or any county or municipality, or any park authority or public recreational facilities authority.

(b) "Urban area" means any area which is urban or urbanizing in character, including semiurban areas and surrounding areas which form an economic and socially related region, taking into consideration such factors as present and future population trends anl patterns of urban growth, location of transportation facilities and systems, and distribution of industrial, commercial, residential, governmental, institutional, resort, and other activities.

(c) "Open-space land" means any land in an urban area which is provided or preserved for (1) park or recreational purposes, (2) conservation of land or other natural resources, (3) historic or scenic purposes, (4) assisting in the shaping of the character, direction, and timing of community development, or (5) wetlands as defined in § 62.1–13.2 of the Code of Virginia. (1966, c. 461; 1974, c. 348.)

SECTION 10–157. CHAPTER CONTROLLING OVER LAWS; POWERS SUPPLEMENTAL

Insofar as the provisions of this chapter are inconsistent with the provisions of any other law, the provisions of this chapter shall be controlling. The powers conferred by this chapter shall be in addition and supplemental to the powers conferred by any other law. (1966, c. 461.)

SECTION 10–158. ACQUISITION OF TITLE SUBJECT TO RESERVATION OF FARMING OR TIMBER RIGHTS; ACQUISITION OF EASEMENTS, AND SO FORTH; PROPERTY TO BE MADE AVAILABLE FOR FARMING AND TIMBER USES

Any public body is hereby expressly authorized, without limiting the authority of the public body to acquire unrestricted fee simple title to tracts, to acquire, by gift or purchase, (1) fee simple title to such land subject to reservation of rights to use such lands for farming or to reservation of timber rights thereon, or (2) easements in gross or such other interests in real estate of not less than thirty years duration as are designed to maintain the character of such land as open-space land. Any such interest may also be perpetual. Whenever practicable in the judgment of such public body, real property acquired pursuant to this chapter shall be made available for agricultural and timbering uses which are compatible with the purposes of this chapter. (1966, c. 461; 1974, c. 259.)

Mr. ROSTENKOWSKI. Mr. Morris?

STATEMENT OF SAMUEL W. MORRIS, DIRECTOR, FRENCH AND PICKERING CREEKS CONSERVATION TRUSTS, INC., ACCOMPANIED BY WILLIAM HOWARD, DIRECTOR OF LAND STEWARDSHIP

Mr. MORRIS. Thank you.

Mr. Sellers and Mr. Howard are testifying partly on the time we have together. We represent here before you 19 different conservation organizations in Pennsylvania, New Jersey, Delaware, and including the two of which we are particularly associated.

I am a director of the French and Pickering Creeks Conservation Trusts, Inc., which operates in northern Chester County, Pa. There are 30,000 people in the combined membership of these 19 organizations, and they have 10,000 acres under easement all together.

I would like to echo what these other gentlemen have said about H.R. 7318. It has a tremendous potential to be and can be enormously useful to the conservation community if it is amended and a few little additions added. At the same time it has great potential for harm if they are not. Certain liberalization of the authorized or qualified donee organizations plus including open space and farmland in the conservation purposes definition are needed.

Now of course what we are afraid of is that if this is not done this would be the third piece of legislation which would continue with the present conservation purposes definition which does not expressly include open space and farmland. There are just all kinds of important open space, important from the point of view of public benefit, that it can be difficult to identify under the present definition of preserving public recreation, historical sites and natural environmental systems. Furthermore, we would really prefer to have a nice clear definition. This in effect would continue what has been the law for 15 years. We are not asking for something new, novel, or radical.

Now having said that, I would like to take just a minute to address some of the questions that you gentleman have asked and that have been brought forward by Treasury. I feel that what we have here in existence today and for the last 15 years is a very fine partnership of the public and the private sectors which have done magnificent things for land conservation. It is Secretary Halperin's duty to defend the revenues, and I am not questioning that. What he seems to be implying is that we should have somebody in government, particularly the Federal Government, to see whether easements should be taken in any particular instance, either possibly the Revenue Service itself or Interior or some other department.

Now I am sure you gentlemen recognize how difficult, almost to the point of impossibility, that would be. The appropriations for these various departments are stretched terribly right now. The only way that this program can be made to work and be beneficial is if you have some trust in the responsible organizations who are taking these easements. You have heard what the other gentlemen have said, Mr. Chandler and these two gentlemen here.

We review these things very carefully. Our particular organization is involved in local planning and we got a grant from the National Endowment of the Arts, $14,000, and we had to match that from private donations, to study this whole question in our area as to what land should be preserved and what historic monuments should be preserved and what should not. That study is almost completed. We published one pamphlet already.

Already we have turned down one easement and we are rather a small organization. We have about 1,365 acres under easement. We turned down one because we were not satisfied with what was being done. I happen to have put some easements on my property and I agree with Mr. Miller that the appraisals are definitely conservative.

It is not a hard job to appraise the before and after value of these easements. I am not an appraiser, I am a lawyer and also a dairyman but it is not that hard. You just do the appraisal twice and it is all over. You follow regular appraisal concepts. We use MAI's as much as possible.

I would like to say one word for the necessity of protecting farmland. I was at a conference the weekend before this last one of the National Trust Historic Preservation and the National Association of Soil Conservation Districts. Just one statistic that was brought out there, today we are losing 6 million acres of farmland every year. That is good farmland—3 million acres through conversion to other uses and another 3 million acres possibly to soil erosion and that kind of thing.

Now how long can we go on with this type of loss? We are going to lose the ability to feed our own people in the cities. We are going to lose the ability to ship farm commodities abroad. There are hungry people that need the food, and in addition it is becoming a very important part of our international policy efforts. I think we really have to pay attention to the crisis that is pending very, very shortly in regard to farmland. Protecting farmland is not going to cost all that much. The only time you get an easement on farmland with much value is in the area fairly near to suburbanization. Out in the Corn Belt I don't think it will make much difference at all.

Now again I say that in order for this type of conservation to work there has to be a partnership of public and private sectors and confidence must be placed in the private sector. We are responsible organizations and we do our best in choosing easements and also in monitoring and enforcing them. You will hear a little more about the enforcement from these gentlemen here. In my judgment a small organization like ours is much better able to monitor because we are close, we see them almost every day, and I think that is important, too. It is just impossible for Government to do it.

Thank you, sir.

[The prepared statement follows:]

STATEMENT OF SAMUEL W. MORRIS, ON BEHALF OF THE BRANDYWINE CONSERVANCY, AND THE FRENCH AND PICKERING CREEKS CONSERVATION TRUST, INC.

This testimony is given on behalf of the following listed Organizations: ACT—Association of Conservation Trusts; the Association of New Jersey Environmental Commissions, the Berks County Conservancy, the Brandywine Valley Association, the Chester County Open Land Conservancy, the Delaware Nature Education Society, the Green Valleys Association, the Lehigh Valley Conservancy, the New Jersey Audubon Society, the New Jersey Conservation Foundation, the Pennsylvania Environmental Council, the Pennypack Watershed Association, the South Branch Watershed Association, the Stoney Brook Watershed Association, the Upper Raritan Watershed Association, the Western Pennsylvania Conservancy, the Wissahicken Valley Watershed Association, the Open Space, Inc., and the Schuylkill River Greenway Association.

H.R. 7318 has several provisions which can be helpful to the land conservation movement, but it definitely needs certain specific additions to make it work, additions which appear small and perhaps minor but which are actually tremendously important. In fact, we have been forced to the unfortunate conclusion that without these changes H.R. 7318 will do more harm than good to the programs of a great many conservation organizations. Fortunately the additions we suggest are neither extensive, far reaching nor complicated. Actually, they merely preserve and clarify the present status quo. It will be a simple matter to effect the necessary changes and make H.R. 7318 a piece of legislation which has tremendous positive value to the land conservation movement.

H.R. 7318 deals with income tax deductions for charitable contributions of certain interests in real property, including "a qualified conservation contribution," which in turn is defined as a contribution of "a qualified real property interest, to a qualified organization, exclusively for conservation purposes." The first two of these requirements are entirely defined in this Bill, but we must look partly to existing Code provisions (§ 170(f)(3)(C) to define the third.

Our position may be briefly summarized by stating that we believe the "qualified real property interest" definition to be helpful to the cause of land conservation, but the "qualified organization" definition and the definition of conservation purposes are harmful. We would also support the elimination of the "sunset date" in section 2 of H.R. 7318, provided of course that the modifications we suggest are adopted. Otherwise even the "sunset date" elimination could be harmful. Another good provision is that which allows for uses of property subject to an open space easement, or other qualified real property interest gift, which are consistently with the conservation purpose.

The conservation movement needs new legislation to clarify the present situation (which is confusing), in fact, needs this Bill, but only if it is properly modified. In more detail, our reasoning is as follows:

We are anxious to have this legislation expressly protect the already existing status of open space and conservation easements as deductible charitable contributions under the Internal Revenue Code. These easements are recorded instruments whereby landowners agree to restrict the use of their properties in perpetuity for open space and conservation purposes. The grant of such an easement is essentially a gift of some of the landowner's development rights, except that in the process the rights are actually extinguished. Such easements have proved over the years to be the most valuable and cost effective land preservation tool we have.

Easements have provided many different types of public benefit, such as: buffering and visual enhancement for scenic highways and rivers, and for public recreation areas, protection of water recharge areas and other water resources, protection of farms and forests, of natural areas for scientific and educational purposes, of history sites and scenes, and a host of others.

Such charitable gifts have been deductible at least since 1964 when a Revenue Ruling on the subject was published. They have many times received the blessing of Congress and of the Treasury Department.[1]

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[1] Those interested in further details may wish to consult "Charitable Gifts of Partial Interests in Real Property for Conservation Purposes," Browne and Van Dorne, in 29 Tax Lawyer 69 (1975), and "The Tax Treatment of the Donation of Easements in Scenic and Historic Property," Stephen J. Small, in Real Estate Law Journal, Vol. 7, pp. 304–319 (Spring 1979), or 9 Environmental Law Review 50009 (March 1979).

The benefit over cost advantages of open space easements are numerous. Even if they had to be purchased, they would cost substantially less than a purchase of fee simple title because a large part of the land value is retained by the owner. A purchase of fee simple title, if carried out by a governmental agency, would be a direct cost to a government conservation program. Even if the purchase were made by a charity, the gifts of the charitable donors who made it possible would give rise to income tax deductions and so would be an indirect cost to government. However, in this case the cost would always be some fraction of the value purchased. The charitable donation of an easement performs a double public benefit as the value of the easement is less than that of the fee, and its deduction value is even less. Furthermore, landowners seem more ready to make such contributions than to contribute toward a purchase program. In such ways philanthropy enhances the benefit over cost ratios of an easement program, and the public is benefited by private philanthropy because the tax deduction is always less than a direct allocation of public funds.

There are also other less direct and immediate benefits. For one thing the maintenance and operation costs of land under easement do not fall on the public. In most cases they continue to be borne by the owners. Conservation and open space easements also serve to prevent or at least to reduce and mitigate such disasters as floods, with a consequent saving in human life and property damage, governmental costs in cleanup and relief operations. Open space easements which protect the water table protect the public water supply and reduce the cost thereof. Farmlands preserved and used to supply nearby urban centers help to protect food prices against ever increasing transportation costs. The list of such less immediate benefits can go on almost indefinitely.

Returning to H.R. 7318 and its three basic requirements for the deductibility of a "qualified conservation contribution." The first of these is that the gift be of "a qualified real property interests," and the definition of such an interest includes, "the entire interest of the donor other than a qualified mineral interest, a remainder interest and a restriction granted in perpetuity on the use which may be made of the real property." This definition, which clearly includes open space and conservation easements, is definitely helpful to the easement programs of many organizations as it does away with some peculiar local common law problems concerning the enforceability of open space or conservation law problems concerning the enforceability of open space or conservation easements which are inherited from English land law of several centuries ago. Furthermore the mineral rights provision will be welcome to many conservation organizations.

On the other hand the definition of "a qualified organization concerns us greatly as it includes only governmental units, certain types of charities such as "community chests" which receive their support from governmental units or from the general public, and charitable organizations which fulfill the complicated requirements of § 509(a)(2) to be classed as "public foundations." We submit that this list should be expanded to include satellite or support organizations to such "public foundations", and also ito include charities which qualify as "private operating foundations."

The main purposes of the provisions in H.R. 7318 regarding qualified organizations seem to be to exclude non-operating private foundations, and to limit qualified organizations to those of whom the Revenue Service requires a high degree of accountability. We fully support both these objectives as they will help to ensure that open space and conservation easements are properly enforced. Nevertheless the actual provisions of H.R. 7318 are too exclusive and restrictive. A high degree of accountability and responsibility is required of both satellite organizations and private operating foundations. The former are very useful small organizations which locally perform certain of the functions of a large spreadout public foundation, better than that large organization could in the local area. Private operating foundations must use all their support income in the performance of their operations and thus are not subject to certain abuses that have occurred with some nonoperating private foundations.

Our other serious problem arises with H.R. 7318's partial dependence on the existing Code provisions of § 170(f)(3)(C) for a definition of "conservation purposes", since on this particular point H.R. 7318 is silent. This definition is limited to: "(i) preservation of land areas for public outdoor recreation or education, or scenic enjoyment; (ii) the preservation of historically important land areas or structures; or (iii) the protection of natural environmental systems."

We submit that a further purpose should be added to specifically provide for the preservation of open space or farmland where such preservation is in furtherance of a local state or national policy. It could also be helpful to make express mention of forests, although forest land might either come under agriculture or as a natural environmental system.

The loss of farmland by conversion to other uses is becoming a matter of grave concern. At a recent conference sponsored jointly by the National Association of Soil Conservation Districts and The National Trust for Historic Preservation, it was said that three million acres of good farmland are lost every year by conversion and another three million by erosion. The supply is finite. We cannot long sustain such losses and continue to feed our urban population. Moreover, any reduction in exportable farm products must have an adverse impact on our foreign policy capabilities. Each acre saved through the use of voluntary open space or conservation easements is important.

We are not seeking to add something new to the law in this respect. It had always been assumed that a charitable gift of an open space easement or an easement on farmland gave rise to a charitable deduction. Then unwittingly, the Tax Reform Act of 1969 threatened to wipe out all easements as gifts of a partial interest. Only when the Bill got to Conference was the day saved by a Committee Report stating it was the Conferees' intent that "open space easements in gross in perpetuity" were undivided interests and came within the undivided interest exception to the 1969 limitations on the deductibility of gifts of partial interests in property. Although this express mention of easements in gross gave rise to some of the local common law problems mentioned above, landowners and conservation organizations have continued to rely on the undivided interest exception to support their programs in connection with farmland and other open space easements, despite legislation in 1976 and 1977 making express reference to easements for conservation purposes and a definition thereof which did not expressly include farmland. Their confidence has been rewarded by private rulings issued on this basis, one as late as the end of 1979.

Now, however, we are afraid that if another amendment to the Revenue Code is enacted dealing with conservation restrictions, but not expressly with farmland, it may be said that three Acts of this nature indicate Congressional disinterest in preserving agriculture even by a simple tax incentive, and this particular easement opportunity will be lost. If that happens, America will be the loser. We submit that it is time that Congress dealt positively with this problem and clarified the situation once and for all.

This concludes the positive part of our testimony, which may be summed up as follows: H.R. 7318 has several good and positive features which will help open land conservation, but in its present form it will do more harm than good. By the addition of a few simple phases, however, the Bill can be made entirely beneficial. The additions we advocate are a reasonable expansion of the organizations qualified to receive a contribution of a qualified real property interest, and express inclusion of farmland protection within the definition of conservation purposes, thus continuing expressly a program which has been supported for many years, on a basis of Congressional intent as expressed in Committee reports.

To repeat, in outline form:

(1) We support those provisions of the Bill which define "qualified real property interest," particularly the mineral right retention provision and that which specifies "a restriction granted in perpetuity on the use which may be made of the property."

(2) We submit that modification of the provisions regarding "qualified organizations" to include additional organizations, and modification of the "conservation purposes" definition to include open space and farm land, are both absolutely essential to the land conservation community. Without these changes, the Bill will do more harm than good. We emphasize that these simple changes are actually only declaratory of existing law.

(3) We also support the elimination of the "sunset date", and the provision with regard to consistent uses, again subject to the Bill being modified by the simple additions we suggest.

(4) The conservation community badly needs appropriate legislation, this Bill in fact, if it is appropriately modified, in order to clarify the present vague and confusing situation.

One further point should be mentioned. H.R. 7318 repeals Paragraph § 170(f) (3)(B) of the Code and replaces it with a new subparagraph. However, the only change made is in the wording of subsection (iii) of subparagraph (B). Subsection (ii) remains the same. If H.R. 7318 passes into law, § 170(f)(3)(B)(ii) will remain exactly as it now is in the Code.

Furthermore, the rest of the provisions of H.R. 7318 pertain only to the new subparagraph (B)(iii) of § 170(f)(3), and do not affect (B)(ii) in any way. (B)(ii) is the subparagraph that supports the rationale or rule that the charitable contribution of an open space easement in gross in perpetuity gives rise to an income tax deduction. It would appear that legislatively this rationale or rule continues unimpaired.

We assume that the sponsors of H.R. 7318 intend this important result. It would seem appropriate therefore that language to this effect be included in the Committee Reports on this legislation. We strongly urge that this be done.

In addition to our positive testimony, we feel impelled to refute some of the assertions made by representatives of the Treasury Department concerning H.R. 7318 and its predecessor H.R. 4611, as well as open space and conservation easements. We will do this in the Appendix to our testimony in chief. The most recent concern seems to be with a suggestion made by Treasury that all deductible open space and conservation easements should contain provisions for public access. This suggestion completely misinterprets the purpose of such easements and if adopted would simply kill the use of easements as a conservation tool.

APPENDIX TO TESTIMONY OF FRENCH AND PICKERING CREEKS CONSERVATION TRUST, THE BRANDYWINE CONSERVANCY AND OTHER CONSERVATION ORGANIZATIONS IN RE H.R. 7318 ON JUNE 26, 1980

As stated at the close of our testimony in chief, the purpose of this Appendix is to refute certain statements made by Treasury officials concerning open space or conservation easements and H.R.'s 7318 and 4611.

(1) PUBLIC ACCESS

The first of such statements concerns a proposed requirement for public access to properties under easement. Such a suggestion misses the entire point of this type of conservation tool. The public purposes served by restrictions on land use are many and varied. A number of these were presented in our positive testimony. Many of them are absolutely inconsistent with giving access to the general public; for example, the protection of a critical wild life habitat, or a farm field.

Open space easements may enhance public recreation, and scenic enjoyment of nearby properties, but to create a public area would require acquisition of the full fee title, or an entirely different type of easement—a right of way or use easement—in other cases. This would be a far more expensive proposition and would also require the continued expenditure of public funds for maintenance in future years.

Furthermore, if an easement were donated, its value for tax deduction purposes would be substantially increased by public access provisions. Thus the indirect cost to government would be increased. Public access would require affirmative rights and their value and cost when added to the cost of the negative or open space easement may actually bring the total up to exceed the fair market value of the land itself. This sounds impossible, but is a fact. The answer lies in the owners' liability insurance and maintenance costs. Actual occasions have arisen in New Jersey where the easement route was found to be impracticable for these reasons. Sometimes a separate arrangement, not in perpetuity or creating actual title rights in the public, can be made for access, but no such requirement should be placed in the Code. Not only is it impractical but it would effectively kill the use of open space and conservation easements.

(2) ELIMINATION OF THE "SUNSET" PROVISION

In testifying against eliminating the "Sunset" provision in H.R. 4611, Secretary Halperin late in 1979 stated that Treasury needed more time to evaluate the effect of conservation and open space easements.

We find this a little difficult to understand since charitable contributions of easements have given rise to income tax deductions at least since 1964.

(3) ASSERTED APPRAISAL DIFFICULTIES

Again in his testimony on H.R. 4611 (and the other points dealt with hereinafter were all part of that testimony), the Secretary expressed a fear that appraisals of partial interests were difficult, and that this difficulty could encourage over-valuations by "aggressive appraisals".

The examples he leaned on throughout much of his testimony had to do mainly with partial interests in personal property. Several mentioned, such as the classic abuse cases of a gift of a remainder interest in a painting with enjoyment retained for life in the owners private home, or a gift of securities in trust to a controlled private foundation for a period of years, had been legislated out of existence as tax deductions by the Tax Reform Act of 1969, and in the painting case even before that. The same was true of "use gifts" of real property.

These examples were therefore irrelevant. It is difficult to see why they were referred to, unless it was to create an adverse atmosphere, an old lawyer's trick.

The truth is that appraising an open space or a conservation easement is no more difficult than appraising the full fee simple title, only a little more time consuming. The method in each case is essentially the same. The only difference is that the value of the easement is the difference between the value of the whole property of the landowner before the easement grant and afterward, and thus two appraisals must be made. If the highest and best use of the property before the easement is for high density residential development, and after the easement grant it is for farming, or for a nature conserve, then the easement value may be substantial. If the highest and best use is the same before as well as after, the easement value will be little. All the necessary appraisals are done by applying regular appraisal techniques.

As for aggressive appraisals, it is hard to prove a negative, and most conservation organizations are not made privy to donors' appraisals. However, we are responsible and accountable conservation charities and Treasury can rely on our integrity. Some of us have refused easements when we found out about an overvaluing appraisal.

(4) THE ARGUMENT THAT SINCE PRESENT ENJOYMENT OF THE OWNER'S PROPERTY WAS UNDIMINISHED, AN INCOME TAX DEDUCTION WAS INAPPROPRIATE

The painting case was cited for this point also. Again, it is completely irrelevant. There was no immediate public benefit in the painting situation; the public benefit is immediate and concurrent with the grant of an easement. Benefit may not depend on possession and enjoyment.

Furthermore, most easement grants do immediately diminish the landowner's use of the property in various ways. Certainly its reduction in value is immediate.

(5) THE CONCERN EXPRESSED THAT EASEMENTS MIGHT NOT BE ENFORCED

Conservation organizations are sensitive to this problem. We want the easements enforced. We are in the business of land saving.

Apart from this, easements are largely self enforcing, because once recorded they virtually prevent obtaining a construction loan.

Moreover conservation organizations take various steps to facilitate monitoring and enforcement. If the conservancy is small, volunteers in their daily travels can easily do the monitoring. Larger organizations may make use of smaller satellites as mentioned in our direct testimony. Some develop a small endowment to pay for these activities. Many place executory limitations in their easement deeds to take effect if the original donee is unable to enforce the easement, limitations to other similar organizations.

Courts of competent jurisdiction also have the power and the duty to enforce a charitable grant, and, finally, so do state attorneys general.

(6) LOCAL ASSESSMENT PROCEDURES

The final objection raised by Secretary Halperin at last year's hearing on H.R. 4611 was that easements might be granted because of a contract with local assessors for a lower assessment, and therefore would not be charitable gifts at all.

The Secretary misunderstood the nature of the special assessment laws of various states which encourage farm or other open land preservation. As far as local real estate taxes go, a landowner who already participated in one of those programs, would be unlikely to gain a further tax reduction by granting an easement to a charitable conservation organization. The same would be true if the easement had come first, because in this latter case he would presumably have already gotten a reduced assessment. Assessments are not legally discretionary with the assessors, and reductions can only be obtained if the landowner does something which reduces the value of the property, such as tearing down a building or granting an easement.

Finally these programs do not produce a public benefit which is equal to that of a perpetual easement. The landowner can always get out of a special assessment program, merely by paying the difference in back taxes.

[The following was subsequently received:]

FRENCH AND PICKERING CREEKS
CONSERVATION TRUST, INC.,
Pottstown, Pa., July 1, 1980.

Hon. DANIEL ROSTENKOWSKI,
Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, Longworth House Office Building, Washington, D.C.

DEAR REPRESENTATIVE ROSTENKOWSKI: This letter is written on behalf of the conservation organizations for whom we testified at the June 26th Hearing. It is a further response to the testimony for the Treasury Department, and a short response to the "recapture problem" raised by Issue No. 7 of the Joint Committee Report and by your own questions at the Hearing.

We have dealt with Treasury's various concerns under separate headings.

(1) Public Benefit

(a) Treasury recognizes that voluntary easements or land restrictions may provide a public benefit, but has doubts as to whether this is always the case.

We fully agree that to deserve a tax deduction there must be public benefit. On the other hand the consensus of conservation organizations which testified is that we do not know of any case where a voluntary easement has not contributed a public benefit. It is impossible to prove a negative, and there may be such instances. We believe strongly, however, that if so they must be few and far between. If Treasury officials know of any, we ask them to come out and tell us. How many "back yard" or cottage beach front situations with absolutely no public benefit have actually arisen? It is easy to conjure up such examples, but what are the facts? We are responsible organizations and will be glad to help the Department to work out methods of preventing abuses, as long as the program as a whole is sustained.

(b) Treasury is concerned that the public benefit from such an easement is not immediate. We answer that if there is public benefit, it necessarily must be immediate. *The benefit lies in the protection of a resource for the welfare of our people*, whether that resource be farmland, a water recharge area, a flood plain, a wildlife habitat, a forest, an historical site, a scenic view, or something else which should be protected.

We have heard, too often, references to the work of art of which possession was retained by the donor. That is just not our case. The distinction which is crtitical lies in the immediate public beenfit produced by the easement grant.

(2) Governmental Supervision and Approval

The Treasury Department argues that in order to assure the public benefit and that the public will get full value for its indirect subsidy, each easement grant should be approved in advance by a government agency and thereafter monitored and enforced in like manner.

If such supervision were really necessary it would be simply impossible, without incurring considerable additional expense, unless the easement program were so restricted as to be useless. If government personnel were expanded to meet the need, one of the best things about the present program, its cost effectiveness, would be lost. In addition far fewer landowners would be willing to submit to the process.

The reason the voluntary easement program has been so effective is because t is a partnership between the private and public sectors and the public benefits derived are subsidized by private philanthropy. Private easement givers cannot ecover the full cost to them of the easement through the medium of tax deductions. Public purchase of an easement is necessarily more expensive than when is given.

Secretary Halperin suggested that without government supervision, the value f the public benefit might be less than the cost to the landowner, and therefore that cost is not an adequate valuation basis. On the other hand the public benefit might be worth more than the easement costs the donor. We will cover valuation problems below, but suffice it to say here that even with a gift of money to a hospital the public benefit may not relate directly to the value of the gift. The only sensible and practical way of valuing a deduction is by its cost to the giver at the time of the gift. Governmental supervision is not an answer to that problem.

(3) *Restricting the Types of Qualified Donee Organizations*

Here we agree with Treasury, although we do wish to enlarge the list slightly. It may be for example, that satellite organizations should be limited to those connected to public foundations. This is only a matter of wording.

(4) *Valuation or Appraisal Questions*

For some reason Treasury seems unconcerned with valuation problems presented by charitable gifts of the whole fee simple interest, or with gifts of remainder interests, but only with easement gifts. Despite Treasury concerns, however, an easement presents no more serious a problem than does a fee simple contribution. The best way to explain this is by examples.

Suppose an easement is placed on a farm in an area subject to development pressures. The methods and approaches to determine the "before value" of the property are routine. So are the approaches to the "after value," of which there are at least two: (a) by capitalizing projected farm income based on the productive capacity of the land as ascertained by soil types, comparable yields on similar farms, etc., which data are readily available from the Soil Conservation Service and the Extension Service; (b) going to similar nearby areas which are not subject to the same development pressures, to find prices for comparable sales of farms for farming. The valuation of an easement on timberland would be similar. Of course, in many areas where there is no great pressure for other uses, farming would be the highest and best use, and the loss to the landowner, hence the value of the easement, and the amount of the tax deduction, would be minimal.

Valuing an easement which preserves a wildlife habitat might be more difficult in theory, but the same general types of approach will hold true, and the easement value will be minimal unless the highest and best use is considerably different from the uses permitted under the easement.

Again it should be noted that the value of an easement to the easement donee, or its value for public benefit purposes, may not clearly relate to the cost of the gift of the donor. The only practical way to ascertain an easement's value, however, is by appraising the donor's loss at the time of the gift.

(5) *Monitoring and Enforcement*

Treasury expresses concern that easements may not be adequately monitored and enforced by the donee organizations. We are concerned with that possibility too, but this is no reason for limiting the effectiveness of the easement program by impractical or costly restrictions and requirements. Government must rely on responsible conservation organizations to fulfill their exempt purposes. We can do, and do do, an effective job of enforcement, more effective certainly than government from the point of view of cost.

(6) *The Conservation Purpose Definition*

Narrowing the scope of the definition is not the answer to protecting public benefits. What is needed is a definition, such as we have suggested, which will cover all the kinds of preservation efforts which are beneficial, thus preventing some important public benefit from being left out, at the same time leaving some room for interpretation in the unusual case, but also emphasizing at the same time the need for public benefit. Our changes accomplish all three of these objectives.

(7) *Conclusion (as to the Treasury Position)*

In conclusion we would add that although we realize it is the duty of Treasury officials to protect the revenues, we think that because of their somewhat limited focus and experience, they have greatly exaggerated the dangers of possible, but so far undocumented abuses, and may have failed to recognize the real public benefit and cost effectiveness of the voluntary easement program. They may also have failed to realize its fragility. Tinkering with a successful and beneficial program which depends for its success on public acceptance and for its low cost on limiting governmental involvement, could be disasterous.

Finally

A question raised in the Joint Committee Description as Issue No. 7 is: should rules be provided to take care of the remote contingency that at some time in the future a property subject to a conservation easement might cease to be used for that conservation purpose?

We believe that with a well planned easement program this is most unlikely to occur, but it is not impossible. It is conceivable for example, that a farm, or a natural habitat, might become so closely surrounded by heavy industry at some future time that it would become impossible to continue the original conservation purpose. In such a situation the then owner of the land might, under the common law "change of circumstances" doctrine, obtain equitable relief from the burden of the easement in court. Certainly if that were to happen equity would seem to call for a return to the public of the price originally paid for the public benefit provided by the easement, whether that price had been paid directly by purchase or indirectly by a tax deduction. It also seems very difficult, however, to provide for this unlikely occurrence in the Revenue Code itself. We would hope that some Regulation for this purpose could be developed by those most interested, i.e., The Revenue Service and the Treasury Department, which would not interfere with the main operation of the easement program.

Sincerely,

SAMUEL W. MORRIS,
President.

FRENCH AND PICKERING CREEKS
CONSERVATION TRUST, INC.,
Pottstown, Pa., July 8, 1980.

Hon. DANIEL ROSTENKOWSKI,
Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, Longworth House Office Building, Washington, D.C.

DEAR REPRESENTATIVE ROSTENKOWSKI: Since the Hearing on June 26, I have frequently thought over your questions about the Mississippi flyway. It seems to me that you were raising a problem going beyond whatever the boundaries of the flyway might be; that you were concerned lest the easement program might get out of hand with wholesale donations of open-space easements which are unjustified from the public benefit point of view. Although such a situation, which might cause a drain on the revenues, would merit the serious attention of all people and organizations in the land conservation movement, we are convinced that the problem will not arise.

It is true that we are requesting certain amendments to H.R. 7318, but we believe they are reasonable as well as important, and that they will not be costly. The principal change we seek would add an additional conservation purpose to the list presently in § 170 (f) (3) (C): preservation of open-space or farmland where such preservation is in furtherance of a local, state or national policy.

We who live in the east coast and Piedmont areas of the country, are greatly concerned with the loss of farmland. This concern is shared by many citizens in California, Oregon and Washington. Loss of farmland through conversion to other uses is rapidly reaching the crisis stage in these areas. The time may not e far off when the same will become true in the cornbelt ond the wheatbelt. Meantime it is an established fact that nationwide the country is approaching he point of diminishing returns on crop yields. Thus we believe that any incentive to saving farmland should be encouraged.

As to the danger of the program getting out of hand, my experience in the farm preservation movement has been that relatively few farmers are willing to give asements on their properties. Most of them do not consider their income suffiient to derive much benefit from a tax deduction. They also tend to regard the arm as their ultimate disability or old age pension. As a rule farmers are very onservative, and will do nothing which might prejudice the ultimate value of heir land, or their present borrowing power. Therefore, I submit that the hanges we suggest in the Revenue Code are unlikely to cause a run on the reasury.

Moreover, in most farm areas, particularly in the corn and wheat belts, agriulture is the highest and best use for the land. Consequently to restrict a property to farming would have little effect on its value, and any possible tax deduction would at most be minimal.

The benefit from our program will be derived from the help given to farm owners in the areas which are most critical to preserve because they are under development pressures, and who have enough income to seriously consider the tax deduction aspects of an easement program. Some of these landowners may not farm themselves but their land is rented to working farmers. Every acre counts, particularly in the pressure areas near urban centers where low transportation costs can be an important factor in restraining urban food prices. Saving land there is a particularly significant public benefit.

Finally, we point out that our proposed amendment to H.R. 7318 will not change existing law, or add anything to the existing program which has been going on successfully for over fifteen years. Our amendment will codify existing procedures, and save the program from ultimate elimination.

For all these reasons we submit that the changes we seek in H.R. 7318 will be very helpful toward continuing a program which gives considerable public benefit at little cost, and will not really cause any substantial revenue drain.

Sincerely yours,

SAMUEL W. MORRIS,
President.

STATEMENT OF WILLIAM SELLERS, DIRECTOR, BRANDYWINE CONSERVANCY

Mr. SELLERS. Mr. Chairman, I am William Sellers. I live in West Chester, Pa. I am the director of environmental management, Brandywine Conservancy. We operate four program areas in the conservancy. The first of these deals directly with local governments assisting them with land use planning and zoning matters. The second is working directly with private land owners to develop short and long range plans for the future use and management of their properties. Third, we work in the historic preservation area to develop adequate information about historic structures in our area. Finally and perhaps most importantly in terms of our easement program, the conservancy has spent almost a million dollars over the last 10 years trying to preserve a stream from pollution and other effects of urbanization. Our easement program has grown out of that essential interest in protecting water resources.

I would like to point out today, in addition to the testimony we have submitted in writing, one thing that is perhaps neglected and that is that the conservation easement, as it has been used by our organization and I think other organizations, is one that deals with land use issues in developing urban areas. In our case, we are not talking primarily about protecting the flyways for ducks, birds or anything else. We are talking about protecting people, not only in the present, but also providing for future needs. I will give you a few examples of those.

The easement lands that we take will, over the long haul (we believe, on the basis of the land use experience that we have had in the 10 or 15 years the conservancy has been in this business) be converted to recreational uses. We feel that in taking easements now we are reducing future land acquisition costs for local government in buying land for recreational and other uses.

We are presently working with several communities on the Brandywine, as an example, on a sewage treatment project funded by the USEPA. One of the things we are trying to do is to provide for advanced land acquisition of land needed for spray application of treated sewage. We are assisting in a water pollution project. In addition, the conservancy is in an area that has extremely fragile ground water resources. We are trying to protect these for future water supplies. The same is true of the surface water itself because our stream is the sole source of water for some 150,000 people. The cost of providing for all of the above in terms of Federal programs would run in the millions of dollars. However, we are not talking about that today, we are talking about a program that is perhaps a small loss of Federal tax income.

In terms of present benefits, the types of areas that we protect include landslide-prone soils, flood plain lands—well, we have been involved with areas that have been the habitat for endangered plants or animals—environmental educational areas, historic sites and sinkhole areas. We have a problem of sinkholes in our area that affects the future of housing and other urban uses.

In the past 3 years, the Congress of the United States has, according to the figures we have received, appropriated $450 million for small watershed protection, paid out $667 million in insurance for flood plain disaster problems, $2 billion in disaster relief, $700 million for the coastal zone management program, $2.1 billion for the Land and Water Conservation Fund, and Corps of Engineers projects for dredging, flood protection and so forth in the millions of dollars.

According to Treasury's information, the total loss to Treasury in expenditures for the conservation easement program has been in the nature of $5 million a year. I would suggest that a program such as ours which is trying to keep people out of these critical areas where they are subject to disasters is saving the Federal Government considerable amounts of money and is protecting local lives and property. Many of these Federal programs presently encourage individuals to develop in hazardous areas. In the end, the U.S. Treasury ends up picking up the tab.

Some people have suggested that the tax deductions in this easement legislation are fully compensatory to the landowner. Our experience has been that the tax deductions do not equal the owner's real losses and in fact the public benefits must be the most important part of our program. We cannot sell conservation easements on tax benefits alone. People have to be concerned about their local community.

I would like to reiterate that we are not just talking about the great out of doors. We are talking about places where people live. We hold easements ranging from 0.5 of an acre to 700 acres for the purposes of protecting water supplies, water resources, and the other benefits that I have mentioned.

As Mr. Howard will point out, our approach has always been to accept easements only where clear public benefits were involved as illustrated by legislation from the local, State, and Federal governments. I might just hold up for you an example of a 6-square-mile area with which we have been involved where we have identified all of the flood plain soils, all the critical water resource areas in that 6-square-mile area. We are not seeking all of the land in this area, we are seeking easement on the particular areas that are outlined in color.

Today, Mr. Chairman, you have asked about the question of extinguishing easements. We, as an organization, will not extinguish an easement without compensation. It is not our intent, however, to extinguish easements. What we have done by mapping of critical areas for water resources is identify those areas that regardless of change in land use in the area are still critical to the water resource. I would submit again that providing water for 150,000 people is a rather important public benefit.

The question of monitoring has come up as well this morning. Mr. Howard can provide the committee with information on our monitoring program. However, I might point out that yesterday we instituted legal action against a violator of our easement program. It is something that we intend to do, we have done, and will do again.

In addition, one of the most important methods for assuring local monitoring, particularly in our area, is that we provide all of the local governments, the county governments, and State governments with a copy of our easement and map. In the last 3 months, one county has published maps of all the open space that is protected within our area and our easements on those maps. So we have very many means of assuring that local governments and county governments can assist using the monitoring program which we operate.

I thank the committee for the opportunity to speak to them this morning. I will be glad to answer questions if you so desire.

Mr. Rostenkowski. Mr. Howard?

STATEMENT OF WILLIAM HOWARD, DIRECTOR OR COORDINATOR OF THE LAND STEWARDSHIP PROGRAM FOR THE BRANDYWINE CONSERVANCY, CHADDS FORD, PA.

Mr. Howard. My name is Bill Howard and I reside in Malvern, Pa.

Mr. Chairman and members of the subcommittee, my charge is to relate the nature or manner in which we conduct our business. To begin with, there is a lot of joint communication between our respective organizations regarding our individual easement programs. First, we share our program resources, including donating personnel and expertise, conducting conferences, workshops, seminars, and offering general information pieces such as brochures, pamphlets, and so forth. Second, organizations such as the Brandywine Conservancy are working with other organizations to help them establish and set up their own easement programs.

There is a great deal of documentation involved or required in completing an easement program. Each organization, of course, has its own procedures and I am going to briefly reference our own program because it is fairly typical or representative in terms of providing the technical basis necessary to fully substantiate a gift of a conservation easement. One. We start with an areawide resources and property plan that is prepared using public planning information. Mr. Sellers has already held up an example of such a plan to the subcommittee.

Two: A natural physical resources inventory plan is prepared for individual properties.

Three: A survey plan showing the property boundaries, inventory information and eased areas is prepared by a registered surveyor/engineer.

Four: Narrative documents outlining the donee/donor responsibilities are prepared by legal counsel.

Five: Legal descriptions of eased areas are prepared by the surveyor/engineer.

Six: Appraisals are prepared by qualified independent appraisers in accordance with the before and after guidelines that have already been mentioned this morning.

Seven: Index files are set up and maintained by the donee organizations and I would say that in almost every case, organizations inspect the eased properties at least once a year.

Eight: Local governments are notified as to what areas have been protected by easements so that they can incorporate the same in their future planning.

Easement documents consist of a narrative agreement, the easement survey plan and a legal description of the protected areas.

As already mentioned in previous testimony, one of the most important elements to consider regarding easements is the valuation question. We recognize that easements are of considerable value to the easement donor but to the recipient donee organization they are of nominal value; in fact, they are considered a liability because of future obligations and responsibilities. We do not involve ourselves directly in the question of trying to determine the value of easements for Federal tax purposes except to suggest to a perspective donor, qualified appraisers with easement experience. We will also try to provide appraisers with any documentation they need to complete the before and after evaluation of the property. Finally, we will counsel perspective donors and appraisers on the long-term implications of an easement donation.

Another important aspect of easement donations is the public access question. You have already heard that perspective donors generally would be very hesitant about donating an easement if public access is a requirement to the program. I will add, because their privacy would be threatened and there would be the question of liability responsibilities. In other words, who—the private landowner or the public—would have responsibility for eased areas.

Many easement programs are located in rural communities. If public access were mandated, there would not be sufficient backup public resources—for example, police protection to adequately deal with possible abuses. In addition, if public access were required, the cost of acquiring easements or subsidizing easements through Federal tax donations would be far higher because public access is a valuable interest in land and compensation would have to reflect those rights being severed from the fee bundle of property rights. In effect, compensation would likely be comparable to the land's fee value, if not higher, because the property owner would still be obliged to maintain the eased areas. Such responsibilities would affect what a future buyer might pay for the land. Requiring public access would, for all intents and purposes, put an end to the easement program, the most important land and water resource conservation tool that we now possess.

This concludes my oral statement. Thank you for this opportunity to address your subcommittee.

Mr. Lederer [presiding]. I would like to thank the panel for being here this morning.

Sam Morris used to sit in front of me in Harrisburg. Sam, sometimes as you know, you told me about this work. As a young boy 35 years ago I had the opportunity to be an inner-city boy who would spend 5 to 6 weeks in the French Creek area. I think the legislation that you come here in support of is commendable.

Mr. Duncan?

Mr. DUNCAN. I have no questions. This has been one of the best panels we have had. You have given us good, diverse information and I know it is going to be helpful. We appreciate your testifying.

Mr. MORRIS. Could I add that the property that Mr. Lederer tried to help us with was bought by a developer and we have had to shell out an enormous amount of money to get even part of it. We are now, or soon will be on the hook for mortgages exceeding $300,000 and part of that sum is for this property. We hope to be able to transfer this property that we bought to Chester County or some municipality but the money to buy that came from philanthropic donations and that is going to be tax deductible to the people who gave it. A good many of the things that Treasury has argued are self-defeating if they analyze them. For example, as Mr. Howard pointed out in connection with the excess problem, that would just mean higher deductions so the real benefit of this program is in the cost effectiveness and the marriage of public and private activities.

Mr. LEDERER. I agree with the gentleman. If we had legislation of this nature, possibly we could have avoided what we are trying to do now in that certain area.

I do want to thank the panel.

Mr. ROSTENKOWSKI. Next is H.R. 5719, Mr. Lederer's bill to amend the Internal Revenue Code of 1954 to clarify the tax exemption of proceeds from certain bingo games.

We will hear from John Jungers, president, Roman Catholic High School Alumni Association, accompanied by Thomas R. Hendershot, counsel.

STATEMENT OF JOHN P. JUNGERS, PRESIDENT, ROMAN CATHOLIC HIGH SCHOOL ALUMNI ASSOCIATION, ACCOMPANIED BY THOMAS R. HENDERSHOT, COUNSEL

Mr. JUNGERS. Mr. Chairman, members of the subcommittee, this is a statement in support of H.R. 5719.

I am John P. Jungers, president and treasurer of the Roman Catholic High School Alumni Association, Philadelphia, Pa. I graduated from Roman Catholic High School in 1950, began my professional career as a public accountant in 1954, commenced public accounting as a sole practitioner in 1960 and in 1973, formed a partnership which is now a professional corporation.

In my capacity as a public accountant, with offices located in center city Philadelphia, and an alumnus of Roman Catholic High School and my desire to devote time to the furtherance of the goals of Roman Catholic High School, it was natural that I assume the position of treasurer of the alumni association. I have held that position for approximately 16 years. I am now in my first term as president of the alumni association.

The 16 years of service as treasurer has given me a background into all the facets of the finances of Roman Catholic High School. I have examined the operating deficit of Roman Catholic High School as prepared by the certified public accountants engaged by the archdiocese of Philadelphia.

Roman Catholic High School, the first free Catholic high school for boys in America, has been in existence since 1890. It was founded as a result of a bequest in the will of Thomas E. Cahill. Thomas E. Cahill, who was deprived of a Catholic education on a secondary level was a self-made man, successful in the commerce of Philadelphia, who willed a portion of his estate to the establishment of Roman Catholic High School. Over the years, the principal of the trust created by his will has been depleted due to economic depressions.

In approximately the last 15 years, the high school, located in center city Philadelphia and having a plant much older than most of the schools in the archdiocese of Philadelphia, has run into deficits. The principal of the trust created under the will of Thomas E. Cahill has simply not been able to earn sufficient funds to meet the operating costs of the high school.

The archdiocese has proposed closing the high school. The considerations of the archdiocese are mainly focused on the newer schools that have a higher student population, with a coeducational mix, and newer plants that do not lend themselves to a deficit. Most schools need at least 1,000 tuition-paying students to break even. The student population at Roman Catholic High School is approximately 850.

In order to prevent the closing of Roman Catholic High School, the alumni association has solemnly committed itself to paying the annual operating deficit of the high school. Formed in 1915, the alumni association is governed by a board of trustees comprised of two representatives of each graduating class. The board meets on the second Thursday of each month, September through July.

The trustees of the alumni association represent approximately 10,000 living alumni. The association has been in existence for many years and has operated as a Pennsylvania nonprofit corporation and is generally exempt from Federal income taxation.

The association for years has been raising money to finance alumni communion breakfasts, student award dinners, et cetera. In 1972, the association commenced the operation and management of our present bingo game. The express and only purpose of any profits from the bingo game was to further the exempt purposes of the alumni association; namely, the perpetuity of Roman Catholic High School by payment of its annual operating deficit.

The association's bingo game is managed by people who are all trustees of the alumni association and there are absolutely no paid professionals involved. Almost everyone who works there is in some way associated with the alumni association. There are men who have given weekends for years to this game.

We understand that in a law passed in 1978 there was provision for the proceeds of bingo games being held not subject to income tax provided that the domicile or State in which the games were operated considered bingo games as legal. In Pennsylvania, while bingo is presently technically illegal, nevertheless, because our game is run with the cooperation of the law enforcement bodies of the city of Philadelphia, not on a commercial basis, and not in competition with any type of gambling, we feel that our game is effectively legal as the law is not generally enforced.

I think it is important to note here that since the association's commitment to pay the annual operating deficit it has paid out over $1 million for that express purpose. Presently, the annual operating deficit is running in excess of $150,000. It can be said without fear of contradiction that if the purposes for which this alumni association is founded and presently operated is frustrated by applying an interpretation to the proceeds of these bingo games as "unrelated business income," the ability of the alumni association to meet its commitment will be limited to possibly a few more years. That, in short, will spell the demise of a center city educational institution whose contribution to the secondary education of center city youth, black, white, Hispanic, and oriental, simply cannot be measured in dollars and cents. Any person who is involved in this alumni association and its commitment is determined that the high school should remain open for the service it provides, not only in the local public interest, but in the interests of the Nation, with its contribution of educated, disciplined youth of all backgrounds.

Gentlemen, that is my statement.

Mr. Lederer. Thank you.

Mr. Rostenkowski. Mr. Hendershot?

Mr. Hendershot. Thank you, Mr. Chairman.

The committee has a copy of my prepared statement and I won't read it to you. Instead, I will summarize my statement, and make just a couple of points.

The Treasury earlier today testified that it did not oppose this legislation in principle, but that it had concerns about defining and administering the term "generally enforcible." I would point out to the committee that the Treasury has already defined that term in connection with section 162(c) of the tax code. The definition appears in Treasury Regulation section 1.1.62–18(b)(3), and I will submit a copy for the record. The Treasury has been administering that definition for some 10 years. During that period, there has been only one administrative case brought before the Treasury under its definition of "generally enforcible." In that particular case, the Treasury had no difficulty in administering its standard, and indeed, concluded that the law in question was not generally enforced. Private Ruling 7206301350A—June 30, 1972.

So I would submit that Treasury's argument concerning the definition of "generally enforcible," is a bogus argument. Indeed, prior to 1978, the Treasury's policy with respect to bingo functioned under that very same definition.

In Pennsylvania, as was pointed out, bingo is currently considered technically illegal, even though the law is not enforced. Legislation passed the Pennsylvania House of Representatives on Tuesday, June 24, which would make bingo legal for charitable organizations, and thereby remove this technicality. It is hoped that said legislation will pass the State senate and be signed into law this year. Of course, that is not certain.

The nature of a criminal statute or amending a criminal statute, is such, however, that the change in the State law will be prospective in nature. The Treasury has undertaken, since 1978, to collect tax for years gone by. Thus, even that change in Pennsylvania State law may not be enough to save an institution like Roman Catholic High School in the absence of the legislation before this committee. Therefore, I suggest and urge enactment of this legislation.

Thank you.

[The prepared statement follows:]

STATEMENT OF THOMAS R. HENDERSHOT, ESQ., OF OBERMAYER, REBMANN, MAXWELL & HIPPEL

I am an attorney, admitted to practice in the District of Columbia and Pennsylvania. I am currently engaged in the private practice of law and in the past have worked as the legislative aide for the Honorable William Green, former representative of Pennsylvania and now Mayor of Philadelphia.

BACKGROUND CONCERNING H.R. 5719

A need for H.R. 5719, the Bill considered today is occasioned by the administrative position taken by the Treasury Department and the Internal Revenue Service and the amendment of the Internal Revenue Code of 1954 by section 513(f), added by Public Law 95–502, § 301(a) (October 21, 1978). As a result of these actions, today profits from the bingo game conducted by a charitable exempt organization will not be taxed as unrelated business income if the conducting of bingo games is not ordinarily carried out on a commercial basis and the conducting of the game does not violate any technical state or local law. If, however, a bingo game run by a charitable organization technically violates a state or local law, the profits will be subject to tax as unrelated business income even though that state or local law is not generally enforced. The Treasury Department has made this inequitable result quite clear in promulgating Treas. Reg. § 1.513–5(c)(3) Example (2). That example provides that proceeds from a bingo game will constitute unrelated trade or business income where a statutory provision prohibiting all forms of gambling is admittedly not enforced against local charitable organizations conducting bingo games to raise funds.

Thus, the current situation will treat identical bingo games operated by identical charitable organizations for identical worthy purposes under practically identical circumstances dfferently where one game is operated in a locale which has no technical prohibition against bingo, and the other game is operated in a locale which does have such a prohibition, which is ignored by the enforcement authorities. This dichotomy becomes even more insupportable when one realizes that the second kind of games, those run in locales where bingo prohibitions are not generally enforced, are conducted openly and above-board and their existence is acknowledged both by the enforcement authorities and the local press. Accordingly, we de not have here a situation involving covert activities, but rather a situation where an unfair burden has been placed on a few worthy activities. I further submit that this result is inadvertent and was not intended by Congress when it added section 513(f) to the Code in 1978.

TREATMENT PRIOR TO SECTION 513(f)

Prior to the addition of section 513(f) to the Code in 1978, the Government won two tax cases holding that tax-exempt organizations were subject to unrelated business income tax on the proceeds of bingo games regularly carried on by the organizations with paid labor even though the organizations involved were not in competition with for-profit businesses. *Clarence LaBelle Post No. 217 v. United States*, 580 F. 2d 270 (8th Cir. 1978), cert. application dismissed, 99 S. Ct. 712: *Smith-Dodd Businessman's Ass'n., Inc.* 65 T.C. 620 (1975).

SECTION 513(f)

Congress responded to these cases by adding section 513(f) to the Code in 1978. Generally, section 513(f) exempts from the term "unrelated trade or business" any trade or business which consists of conducting bingo games where the conducting of such games is not an activity ordinarily carried out on a commercial basis. To get to the heart of the problem addressed here today, Congress further specified that the exemption would be afforded only if the conducting of such games "does not violate any State or local law." This appears in section 513(f)(2)(C).

I believe that the legislative history of section 513(f)(2)(C) concerning the legality of bingo games under state and local law shows that Congress did not consider the case in which charitable organizations were permitted to conduct bingo games notwithstanding a technical state or local law prohibition. Whenever state or local prohibitions are mentioned in the legislative history, such mentions are cursory and presume that such prohibitions are enforced. Thus, House Report No. 95–1608 states at one point that the limitation in section 513(f)(2)(C) "is designed to ensure that no Federal tax benefit is provided for activities which are conducted illegally." H.R. Rep. No. 95–1608, 95th Congress, 2d session 6 (1978), reprinted in 1978–2 C.B. 395, 397.

All other mentions of the limitation are similarly cursory, such as "where state or local law permits such games," or "the conduct of the games does not violate State or local law." Id.

I submit that the records of the debates in the House and the Senate also show that this enforcement issue was not contemplated. For instance, Representative Ullman's remarks, referred to state laws allowing the conducting of bingo games where "state or local law permitting the conducting of bingo games." In summarizing the Bill, Representative Frenzel states at one point that one of the requirements of the Bill is "that the bingo game will be in compliance with State or local law." 124 Cong. Rec. H10,636 (Daily Ed. Sept. 25, 1978).

The debate in the Senate was similarly cursory See 124 Congressional Record S18,043, S18,051 (Daily Ed. Oct. 10, 1978) (Remarks of Senators Long and Anderson).

Accordingly, I think that this Bill, H.R. 5719, presents the first opportunity for Congress to consider this issue and remedy what has become an inequitable and insupportable situation.

TREASURY REGULATIONS

As I mentioned before, the Treasury Department, by way of example in a regulation, has taken the view that bingo is an unrelated trade or business where the game is run by a charity in a locale which prohibits bingo, even though the law is admittedly not enforced. Treas. Reg. § 1.513.5(c)(3) Example (2). The Treasury determined to go ahead with this position, despite two comments received from taxpayers protesting this interpretation. In adhering to its position, the Treasury claimed to rely on the House Report. As a matter of fact, the Treasury, in its preamble to the final regulations, quoted the same language from the House Report which I have quoted above. As I hope you will agree, that language, and all other language in the legislative history, paints with a very broad brush, and I do not believe it was designed to cover the specific situation of a charitable bingo game conducted in a jurisdiction with a blatantly unenforced prohibition on the books.

PENNSYLVANIA LAW

I understand the situation in Pennsylvania to be somewhat similar to the circumstances in five or six other states, although I do not vouch first-hand as to the law in such other states. In Pennsylvania, there appears to be a general prohibition against gambling as set forth in the state statutes. See 18 C.P.S.A. § 5513. It is well known, however, that the prohibition is generally not enforced with respect to bingo games conducted by charitable organizations. I know for a fact that such bingo games are conducted openly in Philadelphia and Lancaster counties, and believe the situation to be similar in other counties such as Northumberland County.

Perhaps in recognition of this situation, just this past Tuesday, June 24, 1980, the Pennsylvania House of Representatives approved a bill that would allow churches and charitable organizations to operate bingo games. The State House voted overwhelmingly, 164 to 26, to approve House Bill No. 1387, and the Bill was sent to the State Senate, where it is expected to pass in September.

While Pennsylvania may itself ameliorate the inequity created by section 513(f) and the Treasury Regulations, I must point out that it is the nature of such provisions that relief be prospective. Thus, even assuming that Pennsylvania legalized charitable bingo games, there will remain a hiatus of a period stretching between December 31, 1969 and the effective date of the legislation of charitable bingo. Accordingly, charities may nevertheless find themselves in the unconscionabel predicament of having ten years or so of bingo proceeds be counted as unrelated trade or business income where the charity's bingo game was never subject to any kind of criminal enforcement and where the state has subsequently removed even the technical prohibitions. It simply should not be the case that charities are treated so differently on the basis of such formal and chimerical differences.

REVENUE AND ADMINISTRATIVE CONSIDERATIONS

At the date of this writing, I do not know whether the Treasury Department will oppose H.R. 5719. I do note that Treasury did not oppose the addition of section 513(f) to the Code.

Anticipating possible Treasury considerations, I would like to take this opportunity to state that I do not believe that the revenue effects should be substantial and that I do not believe the administrative process would be burdened by the enactment of H.R. 5719.

As I have mentioned before, there are few states which prohibit charitable bingo. I would imagine that some of those states, like Pennsylvania, are moving to legalize charitable bingo. Thus, the revenue effect should not be substantial relative to the overall effect of section 513(f), and in those states legalizing charitable bingo, the revenue effect would be limited to the proceeds realized during the hiatus and would not be a continuing kind of revenue effect.

I do not think that H.R. 5719 would impose an administrative burden on the Treasury Department or the Internal Revenue Service. Similar wording as to the general enforcement of state law may be found in section 162(c)(2) of the Code. My research has disclosed that only one administrative decision has come close to dealing with the general enforcement issue under section 162(c)(2) in the entire ten years or so of that section's existence. Private Ruling 7206301350A (June 30, 1972), the only administrative ruling which I have found, did not make the factual determination of whether a state or local law was generally enforced. Rather, a private ruling was issued favorable to the taxpayer on the assumption that the state or local law was not and would not become generally enforced. Thus, it appears to me that the Treasury and the Internal Revenue Service has not been forced to make determinations with respect to the enforcement of state law under section 162(c)(2). I see no reason why the situation would be different if H.R. 5719 were enacted into law.

My research has disclosed few court cases where the general enforcement question was litigated. In the entire ten-year history of section 162(c)(2), I found only five cases to be even approximately relevant. In one of the cases, *James Alex*, 70 T.C. 322 (1978), the general enforcement of the law was conceded by the taxpayer. The other cases appear to have been resolved on the pure tax issue of whether payments prohibited by state law were to be characterized as deductions and thus subject to section 162(c)(2) or as adjustment to gross income and hence not subject to the strictures of section 162(c)(2). In such cases, the courts were not required to address the issue, even if raised by the taxpayers. It appears to me that in only three such cases was the issue raised by the taxpayer: *Dixie Dairies Corporation*, 74 T.C. No. 34 (1980); *Haas Brothers, Inc.*, 73 T.C. No. 95 (1980); *Max Sobel Wholesale Liquors*, 69 T.C. (1977). In *Bert Kreisberg*, 39 T.C.M. 377 (1979), the taxpayer argued that there was no statutory prohibition and did not argue that a statutory prohibition was not generally enforced.

The paucity of litigation on the issue of general enforcement under section 162(c)(2) is remarkable, given the long period of time during which that section has been part of the Code. Thus, the present bill, which would add a general enforcement provision similar to that in section 162(c)(2) should not entail a significant administrative burden.

CONCLUSION

For the above reasons, I strongly urge the enactment of H.R. 5719 into law. I do not believe that H.R. 5719 will pose any significant revenue loss or administrative burden. To the contrary, the enactment into law of H.R. 5719 would be in accordance with the original Congressional intendment in passing section 513(f) and would further the exempt purposes of many fine charitable organizations.

[An attachment to the statement follows:]

TREASURY REGULATIONS (SEC. 1.162 (b)(3))

(3) *Generally enforced.*—For purposes of this paragraph, a State law shall be considered to be generally enforced unless it is never enforced or the only persons normally charged with violations thereof in the State (or the District of Columbia) enacting the law are infamous or those whose violations are extraordinary flagrant. For example, a criminal statute of a State shall be considered to be generally enforced unless violations of the statute which are brought to the attention of appropriate enforcement authorities do not result in any enforcement action in the absence of unusual circumstances.

Mr. ROSTENKOWSKI. Mr. Lederer.

Mr. LEDERER. Mr. Hendershot, it seems this afternoon we have isolated one particular high school. Pennsylvania law as it is presently written if the IRS would want to enforce their enforcement codes, would it be a possibility that they could tax every volunteer fire department or volunteer veterans club in Pennsylvania?

Mr. HENDERSHOT. Yes, there is a danger that volunteer fire companies across the State would not be able to raise the money they currently raise through bingo. There is a danger that literally countless churches, parishes, parish schools and the like would not be able to raise the money they raise through the use of bingo. The same would be true with respect to many social, fraternal, and beneficial organizations, including in some counties, I believe, the Fraternal Order of Police.

Mr. LEDERER. Could I be led to believe that if the Internal Revenue wanted to retroactively go after these organizations they just would not have the assets to pay off the taxes?

Mr. HENDERSHOT. No question about that. They would go out of business.

Mr. LEDERER. Mr. Jungers, the Roman Catholic High School would be an inner city school. How many parish type schools could be closed down in your mind, a ball park figure, in the city of Philadelphia?

Mr. JUNGERS. I don't have access to how many parish type schools could be closed down. A ball park figure in terms of percentage, I will make the broad statement that the Catholic educational process could conceivably be affected to the extent of 100 percent if financing from bingo games was held subject to taxation. I say that for the reason that already all the schools in the archdiocese of Philadelphia are subject to a tuition by the parents and the imposition of this tuition started back in the early 1970's at possibly $35 a year. Now the tuition is as high as $900 a year, $750 from the parents, and $150 from the parish.

In the event that the bingo were to be held unrelated business income subject to income tax, resulting in the closing of the bingos, conceivably the tuition could double and spell the demise of the whole educational system because the parents just would not be able to pay the tuition. That is a personal opinion.

Mr. LEDERER. Then I may be able to safely say that those parish related schools that would close first are those schools dealing with educating the minorities?

Mr. JUNGERS. That is probably true because they are the poorest parish schools to begin with and probably do rely for the most part on the funds from the bingo.

Mr. LEDERER. I thank the panel.

Mr. ROSTENKOWSKI. Mr. Duncan?

Mr. DUNCAN. No questions.

Mr. ROSTENKOWSKI. Thank you, gentlemen, for joining us this afternoon.

Mr. Oppenheimer, Mr. Cohen, Mr. Abel, and Mr. Christian.

Welcome to the committee, gentlemen. There are some familiar faces down there. It is always a pleasure to have you with us. Mr. Oppenheimer, you begin and then we will go to Mr. Cohen, Mr. Abel, and Mr. Christian.

STATEMENT OF JERRY L. OPPENHEIMER, ON BEHALF OF THE ERISA INDUSTRY COMMITTEE

Mr. OPPENHEIMER. Thank you, Mr. Chairman.

I am Jerry L. Oppenheimer, a member of the law firm of Mayer, Brown & Platt, here in Washington. I appear today on behalf of the ERISA Industry Committee, or ERIC.

In order to conserve the time of the subcommittee, we have attempted to coordinate our testimony and if it is agreeable to you we would like for Mr. Cohen to begin.

[The prepared statement follows:]

STATEMENT OF JERRY L. OPPENHEIMER, ON BEHALF OF THE ERISA INDUSTRY COMMITTEE (ERIC)

Mr. Chairman, I am Jerry L. Oppenheimer, a member of the law firm of Mayer, Brown & Platt, here in Washington. I appear today on behalf of The ERISA Industry Committee (ERIC), an association of some 100 major employers, most of which maintain employe benefit plans for nonresident aliens.

ERIC strongly urges prompt enactment of H.R. 7263. It would resolve uncertainty, eliminate unintended results, and reduce conflicts between U.S. and foreign laws. It would clarify the tax treatment of contributions to plans maintained primarily for the benefit of nonresident aliens by generally conforming the tax treatment to the present treatment of those plans under Titles I and IV of ERISA.

U.S. employers doing business abroad customarily maintain retirement and similar plans for the benefit of nonresident aliens. Contributions to these plans are clearly business expenses, and H.R. 7263 would remove any doubt that employers may deduct contributions to them in the case of foreign branch plans or, in the case of foreign subsidiary plans, take the contributions into account in determining earnings and profits.

To protect U.S. workers, ERISA added many new social policy judgments in the form of new Code requirements. These requirements have no relevance to foreign plans and frequently conflict with the law and policy of the host country. Indeed, plans "maintained outside the United States primarily for the benefit of persons substantially all of whom are nonresident aliens" are presently exempt from Titles I and IV of ERISA.

Nevertheless, in private letter ruling 7904042, the Service held that a U.S. employer may deduct contributions to a foreign defined benefit plan only if the plan complies with all of the ERISA amendments to the Code, even if it is impossible to comply because of directly conflicting foreign requirements.

Similarly, in Technical Advice Memorandum 7839005, the Service suggests that a U.S.: employer cannot take into account accumulations under a German plan for purposes of determining earnings and profits, unless the German plan meets the requirements applicable to a domestic plan, including the ERISA requirements.

The U.S. tax treatment of contributions to plans maintained by U.S. employers primarily for nonresident aliens should not depend upon whether the plans meet ERISA standards. The ERISA Conference Report suggests that the Code does not specifically deal with foreign plans because "such plans would have no

need to seek tax deferral qualification". H.R. Rep. 93–1280, 93 Con., 2d Sess. 291 (1974). Upon reflection, this explanation is at best incomplete; it ignores the tax treatment of contributions to these plans and fails to recognize that they often cannot be made to comply with ERISA's requirements. We believe strongly that had there been the time to focus fully on the matter when ERISA passed, Congress would have then adopted provisions similar to those now embodied in H.R. 7263.

The bill would also clarify that a U.S. employer is not taxable on the income of a foreign plan merely because it fails to meet ERISA's requirements. While we know of no case where the Service has attempted to tax an employer on the income of a pension plan maintained for nonresident aliens, any possible ambiguity should be resolved.

The bill as introduced does not include any specific effective date. It would clarify the treatment afforded to foreign subsidiary plans by adding new requirements but without making fundamental changes. Thus, any amendment with regard to subsidiaries should apply to all years.

The amendment regarding taxation of the income of foreign plans is also designed to remove any doubt regarding proper application of the code, and the amendment's effective date should conform to the present effective date of the section in question.

We also view the legislation as essentially removing any doubt regarding the proper application of ERISA to foreign branch plans, and we strongly suggest that the effective date regarding branch plans should be consistent with the effective date of ERISA.

We appreciate the opportunity to appear in support of H.R. 7263, and strongly urge its prompt enactment. I will be happy to answer any questions.

Mr. Rostenkowski. Mr. Cohen?

STATEMENT OF EDWIN S. COHEN, FOREIGN PENSION PLAN TASK FORCE

Mr. Cohen. Thank you, Mr. Chairman.

My name is Edwin S. Cohen. I am a member of the law firm of Covington & Burling, and I am appearing this morning in support of H.R. 7263 on behalf of the Foreign Pension Plan Task Force. Accompanying me are Jerry L. Oppenheimer, a member of the law firm of Mayer, Brown & Platt, who represents the ERISA Industry Committee (ERIC), which is comprised of more than 100 major employers, most of which maintain employee benefit plans overseas; and John F. Abel, vice president and manager of the international department of the international pension consulting firm of Towers, Perrin, Forster & Crosby which was instrumental in organizing the Foreign Pension Plan Task Force. That task force consists of more than 20 corporations which have foreign pension plans.

Many U.S. companies that do business outside the United States through foreign branch offices or foreign subsidiary corporations maintain pension and similar benefit plans for their employees at the foreign locations just as they maintain pension plans in the United States with respect to their employees located here. Substantially all of the participants in these foreign plans are nonresident aliens of the United States.

Pension and similar employee benefit plans maintained in the United States, whether by domestic or foreign employers, are regulated by ERISA and related provisions of the Internal Revenue Code. In order for employers to deduct the costs of their domestic pension plans on their U.S. income tax returns, the plans must be qualified under the requirements of ERISA and the code and funded by cash contributions to a pension trust. The pension plans established overseas for employees located in foreign countries must necessarily conform to the requirements and practices of those countries, which differ in many respects from our own rules in ERISA and the Internal Revenue Code.

Nevertheless, the IRS has recently taken the position in two rulings that for U.S. income tax purposes the employer's foreign pension plan must conform to the U.S. rules, even though it conforms to the rules of the foreign country. In the Service's view the employer would be required to conform the pension plan to the U.S. rules of ERISA even though it might be impossible to do so because it would contravene the foreign law or would require payment of higher foreign taxes by the employer, the employees or both. This creates for the employers an obvious dilemma which the Service indicates it cannot alleviate and asserts only the Congress can remedy.

Now, as Mr. Halperin on behalf of the Treasury indicated this morning in expressing general support of the bill, the Service's view would result in trying to make U.S. policy applicable abroad. As he said, "It seems inappropriate for a U.S. rule to be applied worldwide to foreign persons not resident in the United States particularly in the face of different judgments reached by other countries." This refers to the fact that while we have a set of specific rules under ERISA for our own pension plans and employee benefit plans, foreign governments have in some instances reached different judgments, and it is difficult and frequently impossible to comply with both simultaneously.

Mr. Halperin mentioned this morning the case of a foreign pension plan that might provide for vesting in 11 years whereas our rule requires vesting in employees in 10 years. Another illustration, in Canada it is required that the employee have a pension that would be for his life alone unless he elects to have it continued for the life of the employee's spouse. In our country we provide that the employee will have a joint and survivor annuity for himself and his spouse unless he elects to have it only for his own life. The two rules are in conflict, and it is not possible to conform to both of them simultaneously.

To clarify the situation and eliminate the problems that have been raised by these two recent rulings of Service, this bill would provide a single set of specific rules for the treatment of pension expenses of both foreign branches and foreign subsidiaries in lieu of applying the detailed rules of ERISA that are designed for domestic plans.

Briefly, under the bill the annual cost of a foreign plan would be taken into account for U.S. purposes only if first the plan were either required by foreign law or were announced to the employees and then, second, only to the extent that either amounts are contributed to an irrevocable trust--as we do for the benefit of employees—or the employees' benefits are not subject to a substantial risk of forfeiture.

The amount of the annual pension costs that could be taken into account for U.S. tax purposes would in all events be limited to amounts that are determined under generally accepted U.S. accounting principles. The bill also contains provisions which would insure that it would be applicable only in the case of pension plans substantially all of whose participants are nonresident aliens, and that the employer would in any event not be entitled to take into account, except to a de minimis extent, that proportion of its cost for the foreign plan attributable to benefits for U.S. workers that participate in the plan.

So we think that the provisions of the bill would adequately take care of the problem, and we are pleased to note that Mr. Halperin on behalf of the Treasury expressed general support for the bill this morning.

I might in closing call attention to the fact that in the summary of the departmental positions on page 32 of the Treasury statement this morning there is in respect of H.R. 7263 an ambiguous final sentence. It says, "The Treasury supports the deduction and foreign trust rules, but does not support the provisions regarding computation of earnings and profits."

In the text of Mr. Halperin's statement this morning he indicated that: "Although we have not completed our study of this issue, it is possible that a substantially similar result is reachable under current section 902" with respect to foreign subsidiaries. We would be very happy if the Treasury could reach the result that the bill attempts to reach without the enactment of legislation if he can convince his associates at the IRS but thus far the IRS has taken a different view. And so he adds the sentence in the text, "Thus, we would have no objection if these legislative amendments were made applicable retroactively in the case of foreign subsidiaries."

So, if Mr. Halperin is not able to succeed beyond our efforts in convincing the IRS of the position that we take and that a bill would produce, we would feel that the committee should enact the necessary legislation and, as he suggested, make it applicable retroactively in the case of foreign subsidiaries.

His statement indicates that he would not support making the bill retroactive with respect to foreign branches although he has made it clear that he thinks that the policy should be the same and he supports doing so for the future. We would respectfully suggest to the committee that, since there is no difference in the applicable policy, the bill should apply retroactively in the case of foreign branches just as in the case of foreign subsidiaries. Otherwise we would have lengthy litigation to no end because we seem to be in agreement with the Treasury as to the appropriate policy which would be enacted by this bill. So we would suggest that the bill carry an effective date that would be retroactive both for the branches and the foreign subsidiaries.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF EDWIN S. COHEN, ON BEHALF OF THE FOREIGN PENSION PLAN TASK FORCE

My name is Edwin S. Cohen. I am a member of the law firm of Covington & Burling and I am appearing this morning in support of H.R. 7263 on behalf of the Foreign Pension Plan Task Force. Accompanying me are Jerry L. Oppenheimer, a member of the law firm of Mayer, Brown & Platt, who represents the ERISA Industry Committee (ERIC), which is comprised of more than 100 major employers, most of which maintain employee benefit plans overseas; and John F. Abel, Vice President and Manager of the International Department of the international pension consulting firm of Towers, Perrin, Forster & Crosby, which was instrumental in organizing the Foreign Pension Plan Task Force. That Task Force consists of more than 20 corporations which have foreign pension plans.

In response to the Chairman's request that commonly interested groups designate a single spokesman, I shall make the principal statement on behalf of the group and Mr. Oppenheimer and Mr. Abel may add certain supplementary remarks. In addition, members of the Task Force and others may file statements for the record.

I. BACKGROUND

Many U.S. companies that do business outside the United States through foreign branch office or foreign subsidiary corporations maintain pension and similar benefit plans for their employees at the foreign locations just as they maintain pension plans in the United States with respect to their employees located here. Substantially all of the participants in these foreign plans are nonresident aliens of the United States, and the plans are typically subject to rules and restrictions prescribed by foreign law, including foreign income tax law. Although it is permissible in some countries to fund part or all of a pension or similar benefit plan through contributions to a trust or similar funding vehicle, this is not normally required. Indeed, some countries, such as Germany and Japan, even tax the employees currently on part or all of their future pensions if they are funded in a pension trust of the type we generally have in the United States. Instead, employers are permitted and, in some countries, encouraged to accrue the pension liability on their books as pension reserves. These accruals of pension liabilities are generally deductible under the foreign country's income tax law if the particular pension plan requirements of the foreign country are met.

Pension and similar employee benefit plans maintained in the United States—whether by domestic or foreign employers—are regulated by ERISA (the Employee Retirement Income Security Act of 1974) and related provisions of the Internal Revenue Code. In order for employers to deduct the costs of their domestic pension plans on their United States income tax returns, the plans must be "qualified" under the requirements of ERISA and the Code and funded by cash contributions to a pension trust. The pension plans established overseas for employees located in foreign countries must necessarily conform to the requirements and practices of those countries, which differ in many respects from our own rules in ERISA and the Code.

The Internal Revenue Service has recently taken the position in both a private ruling and a technical advice memorandum that for U.S. income tax purposes the employer's foreign pension plan must conform to U.S. rules. In both cases considered by the Service, substantially all of the employees covered by the plans in question were nonresident aliens, the plans conformed to the pension plan rules of foreign countries, and the expenses of the plans were deductible under the income tax laws of the host countries. In the Service's view, the employers were nevertheless required to conform the pension plans to the U.S. rules even though that might be impossible because it would contravene the foreign law or would require payment of higher foreign taxes by the employer, the employees or both. This creates for the employers an obvious dilemma which the Service indicates it cannot alleviate and asserts only the Congress can remedy.

The private ruling concerned a pension plan maintained by a foreign branch of a U.S. corporation in a foreign country. The Service took the position that because the pension plan requirements of the Code were not fully met, the contributions to the pension trust were not deductible for U.S. income tax purposes either at the time they were paid by the employer to the trust or at the time that the benefits were actually paid by the trust to the participants and beneficiaries.

The technical advice memorandum involved the foreign subsidiary of a U.S. corporation. In accordance with local law and practice, the subsidiary reflected its pension liability to its employees by an annual accrual in a pension reserve. It did not fund the plan through contributions to a pension trust, as would be required of a qualified plan under ERISA. The Internal Revenue Service concluded that the foreign subsidiary could not reduce its earnings and profits by the amount of its properly accrued pension plan expense liability. This failure to recognize the foreign subsidiary's legitimate pension expenses would result in an unwarranted increase in the U.S. parent corporation's net U.S. tax liability on dividends received from its foreign subsidiary.

II. EXTENSION OF U.S. SOCIAL POLICY TO FOREIGN PLANS

The Service's attempt to extend the application of U.S. pension policy to foreign pension plans maintained primarily for the benefit of employees who are nonresident aliens is questionable as a matter of law, unwise as a matter of tax policy and would lead inevitably to protracted litigation.

A. Statutory authority

In the case of a foreign branch of a U.S. company, the deductibility of its pension expenses directly affects the company's U.S. tax liability. There is no express exemption from the provisions of ERISA for plans maintained by branch operations. While there were difficulties in qualifying a foreign pension plan for U.S. tax purposes prior to the enactment of ERISA, qualifying such plans is virtually impossible under ERISA. Foreign plans maintained primarily for non-resident alien workers are expressly exempt from the labor law provisions of Title I of ERISA and the termination insurance provisions of Title IV. The legislative history of ERISA does not suggest an affirmative Congressional intention to subject such plans to the tax provisions of Title II, although Title II contains no express exemption for them. The application of the ERISA provisions to such plans makes it difficult, more costly in terms of foreign taxes and, in some cases by reason of contrary foreign law requirements, literally impossible to qualify a foreign pension plan for purposes of U.S. tax law.

There is even less basis in law for applying the U.S. tax deduction rules to the pension expenses of foreign subsidiary corporations. Since those corporations are not U.S. taxpayers, they do not claim deductions for their pension expenses. Their pension expenses are relevant to U.S. tax law only insofar as they reduce the corporation's earnings and profits. If the foreign corporation pays dividends to its U.S. parent corporation and the pension expense does not reduce its earnings and profits, the amount of foreign tax paid that is available for credit against the U.S. tax on the dividends will be artificially reduced. Earnings and profits is essentially an economic measure of a corporation's ability to pay dividends. Where a foreign corporation's pension expense represents a bona fide liability that would reduce the amounts available for the payment of dividends, it should reduce the corporation's earnings and profits. This has been the consistent and long-standing practice in this area, a practice that had not been questioned prior to the recent issuance of the technical advice memorandum by the Service.

B. Policy considerations

The Service's interpretation of the current law is based on the notion that ERISA requires the Service to enforce the United States' pension laws outside this country for the benefit of foreign workers even where the foreign government has different rules which at times conflict with our own. Our pension rules are the embodiment of a social policy reflecting historical, economic and social factors that, in combination, are unique to the United States. Other countries with different circumstances have taken other approaches that best meet their particular needs. Although many would acknowledge that our policy is a good one that has served us well, no one would suggest that it is the only rational means of providing retirement security to workers. In the absence of a universally acknowledged "correct" pension system, a conclusion that ERISA requires the United States to export its pension rules is disruptive to the conduct of American business abroad and places U.S. companies doing business abroad in an untenable position.

As I have noted, in some instances the requirements of foreign law are flatly irreconcilable with those of ERISA. For example, under Canadian law, in order to qualify a retirement plan that provides benefits in the form of a life annuity, the plan must provide that a retiring employee will receive the benefits in the form of a single life annuity unless the employee chooses another form. In contrast, under U.S. law, if a plan provides benefits in the form of a life annuity, in order to qualify it must provide married employees with a joint and survivor annuity for the lives of the employee and the employee's spouse unless the employee chooses to receive the annuity in a different form. Though as a practical matter the difference between the U.S. and Canadian rules seems minor, it is not possible for the employer to comply with both rules simultaneously.

In other cases foreign law makes the cost of complying with U.S. pension law prohibitive. For example, the German government has created tax incentives for retaining assets in productive use in business, and this is the overwhelming practice of employers in that country. Consequently, for German income tax purposes employers may accrue as deductions the current addition to reserve for their pension plans. However, if they contribute assets to a funding vehicle, either the tax deduction to the employer is severely restricted or the employees are charged with current taxable income.

These examples illustrate that U.S. companies doing business abroad cannot reasonably be asked to revise their foreign plans to comply with U.S. pension law and still conform to the pension law and practices of the foreign host country. We think that, in determining U.S. tax consequences, it is inappropriate and unfair to ignore the legitimate pension costs associated with doing business abroad where the host country has chosen to provide retirement security rules for its workers under a system different from our own.

III. OVERSEAS EFFECT

Deferring to foreign pension rules would not deprive foreign workers of reasonable pension benefits and safeguards for those benefits. The majority of U.S.-owned overseas businesses are situated in the industrialized countries of the world—primarily the countries of western Europe, Japan and Canada. These countries have developed pension systems that provide adequate retirement security for their citizens. Differences in history, legal structure, and culture have, in some instances, produced pension systems that provide even broader benefits than our system does. For example, whereas employers in the United States are free to choose whether or not to establish a pension plan and what level of benefits to provide, in Italy and numerous other countries every employer is required by statute to pay its employees upon retirement a severance indemnity of a specified amount based upon years of service. However, the practice in most of these countries is not to set funds aside in a separate trust, and, indeed, under the law of many of these countries trusts or similar funding vehicles are unknown. A U.S. company doing business in Italy would not be able to deduct the accrued cost of its severance indemnity plan under the Internal Revenue Service's interpretation of current law even though the cost is deductible for Italian income tax purposes. Likewise, an Italian subsidiary of a U.S. company would not be able to reduce its earnings and profits on account of its accrued severance indemnity expenses.

IV. H.R. 7263

To clarify this situation and to eliminate the problems raised by the Service's rulings, H.R. 7263 would provide a single set of specific rules for the treatment of pension expenses of both foreign branches and foreign subsidiaries in lieu of applying the detailed rules of ERISA that were designed for domestic plans. Briefly stated, under the bill the annual cost of a foreign plan would be taken into account for U.S. tax purposes only if the plan were either required by foreign law or announced to the employees, and then only to the extent that either amounts are contributed to an irrevocable trust for the benefit of employees or the employees' benefits are not subject to a substantial risk of forfeiture. The amount of the annual pension cost that can be taken into account would in all events be limited to amounts determined under generally accepted U.S. accounting principles.

The provisions of H.R. 7263 would be applicable only in the case of pension plans substantially all of whose participants are nonresident aliens. Moreover, the employer would in any event not be entitled to take into account under H.R. 7263 that proportion of its cost for the foreign plan, above a de minimis level, attributable to benefits for U.S. workers participating in the plan.

H.R. 7263 would also amend section 679 of the Code to insure that income earned by a trust under a funded plan primarily for the benefit of nonresident aliens would not be taxed to the employer.

The effective date of the provisions of H.R. 7263 are not stated. In the case of foreign branch operations of U.S. companies, the problem caused by the asserted need to comply with U.S. pension law is largely attributable of the failure of ERISA to provide adequate rules regarding foreign pension plans. Therefore, in order to fill the gap the effective date of the provisions applicable to foreign branches should relate back to the date of ERISA's enactment.

As applied to foreign subsidiaries, this bill would clarify and add specific rules to existing law without making any fundamental change. In the interest of avoiding protracted litigation with respect to past years, these provisions should be made effective in the case of foreign subsidiaries for all past years.

The effective date of the amendment to Section 679 of the Code should conform to the effective date of that section.

V. CONCLUSION

Enactment of H.R. 7263 would remove an unfair and unwarranted burden and dilemma for U.S. companies that provide pension plans for foreign employees; it would relieve the Service and employers of the unmanageable burden of determining whether foreign pension plans qualify under ERISA as well as under foreign law; it would eliminate the need for lengthy litigation to determine the precise applicability of U.S. pension rules to foreign pension plan; and it would provide a clear tax rule that would enable the business community to plan effectively for the foreign pension programs.

Mr. ROSTENKOWSKI. Mr. Abel?

STATEMENT OF JOHN F. ABEL, FOREIGN PENSION PLAN TASK FORCE, ON BEHALF OF TOWERS, PERRIN, FORSTER & CROSBY, INC.

Mr. ABEL. Thank you, Mr. Chairman.

My name is John F. Abel. I am vice president and manager of the international department of Towers, Perrin, Forster & Crosby, Inc., which is a leading and old consulting firm specializing, among other things, in pension plans and similar employee benefit plans. I am in charge of those activities as they relate to such plans outside the United States.

I have prepared a detailed statement for the benefit of the committee which gives examples of the problems with which our clients have to deal when we try to manage pension plans in foreign countries; namely, France, Germany, and England. Then I have tried to generalize about the practices in other countries to illustrate the impossibility of reconciling the requirements of the foreign government with the requirements of the Government of the United States. I think if the committee will take a look at these examples they will see that it is an impossible task to accomplish what apparently is being required and that we absolutely have to have some kind of clarification of the implications of these acts which our clients have to take in foreign countries where they are involved—for example, when it comes to the U.S. tax implications of those actions.

I would be glad to answer any questions about foreign plan practices but if there are no other questions, I will close this submission with that brief comment.

[The prepared statement follows:]

STATEMENT OF JOHN F. ABEL, VICE PRESIDENT AND MANAGER, INTERNATIONAL DEPARTMENT, TOWERS, PERRIN, FORSTER & CROSBY, INC.

My name is John F. Abel. I am Vice President and Manager of the International Department of Towers, Perrin, Forster & Crosby, Inc. On behalf of my organization and a group of more than twenty major corporations, I support H.R. 7263 and respectfully urge this Subcommittee to report it out favorably at the earliest possible date.

Towers, Perrin, Forster & Crosby, Inc. is an organization of management consultants specializing in human resource, actuarial, and selected general management services on a world-wide basis. For more than sixty years, we have been assisting corporate management in a variety of business-related matters. We maintain a professional consulting and support staff of more than 950 people and serve more than 3,000 clients. Of these, more than 500 are companies that do business in more than ninety countries. We employ more than 175 actuaries. Our comments reflect the experience we have gained in tailoring pension and other benefit plans to suit the needs of our diverse group of clients in the United States and abroad.

TPF&C has been working with a group of more than twenty companies that are concerned about the uncertainties governing the tax treatment in the United States of contributions made by employers to foreign pension and similar plans. We also maintain pension plans in six other countries for our employees located in those countries.

It is on behalf of these companies, as well as my own firm, that I support enactment of H.R. 7263.

I wish to share with you the kinds of problems a typical corporation faces in its efforts to manage these types of programs in several different countries. Such a company has to comply with all local laws as they may be modified from time to time. It needs to know in an unambiguous manner how the contributions made and the reserves established under pensions or similar programs in these countries are to be treated under United States tax laws.

Let me briefly describe the types of legal requirements and customary local practices that an employer must conform with in maintaining its pension plans in three major industrial countries. We will take Germany, France, and the United Kingdom as examples. This should place the potential nondeductibility of such pension costs in better perspective.

GERMANY

Plans providing retirement income to supplement Social Security are widespread in Germany. Typically, these plans are financed by company-held reserves, rather than through contributions to a trust fund, as in the United States. Funding as we know it is in fact discouraged by being given less favorable tax treatment and can result in immediate taxation to the plan's beneficiaries.

Vesting schedules under German plans differ from the ten-year cliff vesting schedule most common in large United States pension plans. In Germany, vesting is required after either attainment of age 35 and completion of ten years of participation, or attainment of age 35 and three years of participation with twelve years of service.

Liabilities under book reserve arrangements are calculated in accordance with German tax law, using a uniform prescribed method and set of assumptions. This is designed to restrict the tax deduction rather than reflect the true economic picture of the pension plan and the company. The combination of tax law, labor law, obligations law, and reinsurance provisions makes an employer's pension promise virtually an irrevocable liability, and employees also receive assured benefit protection under a program analagous to plan termination insurance in the United States.

To attempt to conform such a German plan to United States law requirements for funding, vesting, participation, benefit accruals, and joint and survivor benefits would make it unrecognizable in comparison to plans maintained by local German employers. It would result in a plan that varied from comparable local plans for reasons that would be irritating to the German government and socially inexplicable to German employees. Moreover, it could require increased costs on the part of the United States employer, e.g., through paying higher German taxes.

FRANCE

Pension plans in France are quite different, still, from those in both the United States and Germany.

Basic social security benefits are supplemented by compulsory pensions provided through multi-employer pension systems covering groups of employees. Two important systems are ARRCO, covering all employees, and AGIRC, covering essentially "exempt" employees. These systems provide a range of retirement and survivor pensions. Both employers and employees are required to make contributions. Most companies provide supplementation through the multi-employer pension system. Private pension plans supplementing the compulsory systems are not common.

As for funding, the system operates on a pay-as-you-go basis, with contribution levels basically fixed, subject to minor variations. Typical total contributions involving employees and employers are 6.4 percent of pay at ARRCO and 16.48 percent (maximum rate) at AGIRC.

Vesting is full and immediate in accrued "pension points" based on the percentage of employer and employee contributions to the plan. Pensions are indexed in line with general salary increases.

Again, it can be seen that the local benefit practices are far different from those in the United States, cannot be ignored by companies operating in France, and the United States tax consequences of contributions to these plans should be clear.

UNITED KINGDOM

Practices in the United Kingdom are closer to those in the United States than in France or Germany, but still somewhat at variance.

In addition to basic Social Security benefits, the United Kingdom also requires a minimum "earnings-related pension scheme," as it is called there. Employers that "contract in" pay premiums to the scheme, and may establish a supplementary pension plan that integrates with that scheme.

Employers that "contract out" must provide the minimum level of benefits, and then may provide a supplementary plan.

Plans providing retirement income and other benefits over and above the minimum required are virtually universal in this country. And, while they are typically financed on an advance-funded basis by contributions to trust funds or insurance companies, United Kingdom practices may differ in other respects—such as providing different types and amounts of death benefits than those customarily found in United States plans, or in integrating with Social Security.

Full vesting is required after attainment of age 26 and five years of service.

Thus, these three countries illustrate the difficulties of maintaining pension or similar benefit plans in several countries. One country (France) mandates both the benefit provisions and the funding method; one (United Kingdom) encourages the type of funding with which we are familiar, but has different requirements for benefits amounts; in the third (Germany), the government prescribes the amount which may be deducted for local tax reasons. Other countries have other practices and requirements.

These examples give you a flavor of the wide variations that abound through the nations of the world, with respect to pensions and similar programs. In many countries, benefits are legally required; in many countries, funding facilities as known in the United States are unavailable or the type of funding is mandated as well. The Western industrialized nations all have established social security systems and tax and funding rules for private plans which supplement those systems. And in other countries, the governmental regulations control the payment of benefits granted or required.

There are wide variations in types of benefits required from country to country. But, in most foreign countries there are some kind of benefits—defined contribution plans or defined benefit plans—which an employer for one reason or another must adopt. As mentioned at the beginning of my remarks, it is necessary that the employer have a clear understanding of how the amounts contributed to such plans will be treated for United States tax purposes, and it is for this reason that we strongly support this bill.

I would be glad to answer any questions about foreign plans.

Thank you.

Mr. Rostenkowski. Your entire statement will be made part of the record.

Mr. Christian?

STATEMENT OF ERNEST S. CHRISTIAN, JR., ON BEHALF OF UNITED BRANDS CO.

Mr. Christian. Thank you, Mr. Chairman.

I am Ernest S. Christian, Jr., and I am appearing on behalf of United Brands Co. We strongly support H.R. 7263 which would clarify the deductibility of employer contributions to employee plans created outside the United States and maintained for persons, substantially all of whom are nonresident aliens. Properly, in the case of such a plan which meets the requirements of foreign law, employers should be able to deduct contributions whether or not the plan meets the somewhat different requirements in the United States which are designed to apply only to plans created in the United States primarily for U.S. workers.

Mr. Cohen has described in detail the background and rationale of H.R. 7263 as it relates to the deductibility of contributions to plans created outside the United States for nonresident aliens. There is, however, a closely related matter involving plans that are created in the United States and that provide pensions in one combined plan for some nonresident aliens as well as for a larger portion of the U.S. workers.

This related technical change as described in Treasury's written statement relates not to the deductibility of the employer contributions, but instead relates to the imposition of a tax on nonresident alien pensioners under such plans. Briefly, under present law when a retired nonresident alien receives a pension from a U.S. plan for services rendered outside the United States a part of his pension may be subject to a 30-percent withholding tax. The theory is that a portion of each pension payment represents income from investments made from the U.S. pension trust. However, these pension payments are in reality merely deferred compensation for services rendered outside the United States and nonresident aliens are not supposed to be taxed on compensation for services rendered outside the United States.

Therefore, U.S. tax treaties uniformly, almost automatically, eliminate the tax on these pension payments, but the United States does not have tax treaties with many of the less developed countries. Thus, the burden of tax falls in a regressive manner almost entirely on low-income retirees in the less developed countries in South America and elsewhere. In effect, the United States imposes a higher rate of tax on those low-income retirees than it imposes on our own citizens of the same income level. The proposed technical change described by the Treasury's written statement would eliminate the 30-percent tax where the pension is paid to the resident of a "beneficiary developing country" within the meaning of the Trade Act or to a resident of any other country which provides reciprocal treatment for U.S. retirees.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF ERNEST S. CHRISTIAN, JR., ON BEHALF OF THE UNITED BRANDS CO.

Mr. Chairman and members of the Committee, I am Ernest S. Christian, Jr., of the law firm of Patton, Boggs & Blow. I am appearing on behalf of United Brands Company in support of H.R. 7263 and to urge the Committee to remedy a closely related technical defect in the tax treatment of pensions provided by U.S. businesses to their nonresident alien employees under qualified plans. These amendments, which are fully justified by considerations of tax policy, would encourage U.S. businesses to provide retirement security for their nonresident alien employees.

I. NONQUALIFIED PLANS

H.R. 7263 would codify and clarify an important aspect of the tax treatment of nonqualified deferred compensation plans maintained for the benefit of persons substantially all of whom are nonresident aliens.

The Internal Revenue Service has recently taken the position that a domestic corporation which maintains a funded deferred compensation plan covering foreign workers is not allowed a deduction at the time contributions are made to the plan unless the plan is qualified under section 401. Furthermore, the Service takes the position that in the case of a defined benefit plan (where employer contributions are determined by aggregate actuarial assumptions and separate accounts for each plan participant are not maintained) a deductio for the amount of employer contributions is not allowable at either (i) the tim employees become vested, because the separate account requirement of sectio 404(a)(5) is not satisfied, or (ii) the time an employee receives distribution because an allocation of the distribution between employer contributions an trust earnings cannot be made.[1] Therefore, the Service contends that a domesti corporation is never allowed a deduction for contributions to a nonqualifie defined benefit plan covering foreign branch workers.

This result is wholly unjustifiable in terms of tax policy. U.S. policies relate to retirement incomes, such as minimum participation, vesting and other requir ments under section 401(a) are not relevant where foreign workers are co cerned. Indeed, foreign law often makes it impossible to satisfy the section 40 requirements for plan qualification. H.R. 7263 would make it clear that a deduc tion is allowed for amounts paid or accrued to provide deferred compensatio under a nonqualified plan where substantially all the beneficiaries are nonres dent aliens, provided that certain conditions designed to assure integrity of th plan and reasonableness of the claimed deductions are satisfied. H.R. 726 would also make it clear that "accumulated profits" are properly reduced b amounts accrued under a deferred compensation plan for nonresident alie employees.

These are needed and appropriate clarifications which United Brands Company strongly supports.

II. QUALIFIED PLANS

In addition to these uncertainties in the treatment of nonqualified plans whic are clarified by H.R. 7263, there is a closely related technical defect in the presen law treatment of pensions provided by a U.S. business to its nonresident alie employees under a qualified plan which covers both U.S. and foreign employees Qualified plans which cover U.S. employees generally have a U.S. situs. However a nonresident alien pensioner is subject to the 30 percent withholding tax on th accretion element of distributions from a U.S. situs pension trust.[2] In contrast nonqualified plans which cover only nonresident alien employees generally hav a foreign situs, and therefore the beneficiaries of such plans pay no U.S. tax. Fo the reasons described below, the taxation of the accretion element of pension received by nonresident aliens under qualified plans is arbitrary and excessive and cannot be justified on tax policy grounds. Furthermore, the tax treatment of distributions to nonresident aliens from qualified plans should not be less favorable than the treatment accorded distributions from nonqualified plans.

Section 871(f) should be amended to eliminate the 30 percent withholding tax on retirement annuity payments received by a low income nonresident alien under a qualified penson or profit-sharing plan for services rendered outside the United States. The burden of that tax falls regressively on lower income pensioners in less developed countries of Latin America and elsewhere. The U.S. imposes a much higher level of tax on these individuals than it imposes on U.S. citizens with the same annual income.

The general rule for U.S. taxation of nonresident aliens is that (i) a nonresident alien investor is subject to a flat 30-percent withholding tax on dividends, rents, etc. received from U.S. sources, but (ii) a nonresident alien employee is not taxed on compensation received from U.S. sources for services rendered outside the United States.

The problem is that under section 871 a nonresident alien employee who receives part of his compensation in the form of retirement annuity payments under a qualified pension or profit-sharing plan is incorrectly treated as a nonresident alien investor after he retires. He is subject to the 30-percent withholding tax on that portion of the retirement annuity payments which corresponds to the accretions on contributions previously made under the qualified plan. Correctly treated, however, such a nonresident alien individual should be considered as receiving nontaxable compensation for services—part of which is current compensation paid in the form of direct salary during his working years and part of which is deferred compensation received later in the form of retirement annuity payments under the employer's qualified pension or profit-sharing plan. Under section 1348, for example, in the case of a retirement annuity payment received by a U.S. citizen, both the accretion element and the contribution element are treated as compensation.

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[1] Private Ruling LTR 7904042 (Oct. 25, 1978).

[2] Section 871(a)(1)(A) provides in pertinent part: "There is hereby imposed for each taxable year a tax of 30 percent of the amount received from sources within the United States by a nonresident alien individual as * * * annuities * * * and other fixed or determinable annual or periodical * * * income." U.S. Tax Guide for Aliens 4 (IRS Pub. 519, 1979 ed.).

When section 871 was enacted, it was believed that the 30-percent figure represented a generally appropriate rate of tax on what was typically only one source of a nonresident alien's income.[3] Also, the flat 30-percent rate on gross U.S. source investment income assumed that nonresident alien investors would have other sources of income in their home countries (or elsewhere) which would not be taxed by the United States.[4] In the case of low income pensioners, however, the two assumptions of outside income and the appropriateness of the 30-percent rate simply do not apply. First, pension payments typically are the only source of income for alien pensioners who reside in developing countries. Second, the current U.S. tax on their income greatly exceeds the tax burden of comparably situated U.S. citizens because the 30-percent tax rate is a flat rate on gross income—nonresident alien pensioners may not take such usual deductions as the zero-bracket amount, old age, or any other exemption or deduction. The 30-percent tax also greatly exceeds whatever tax may be imposed by the home countries of these nonresident aliens, so that the U.S. tax is not absorbable by them in the form of a tax credit.

The 30-percent withholding tax substantially reduces the pension actually received by the selected number of nonresident aliens who are subjected to the tax. Moreover, the reduction in the amount of pension received by a nonresident alien pensioner reflects a much higher rate of tax than the U.S. imposes on its own citizens with comparable levels of annual income. Once retired, nonresident aliens who reside in less developed countries typically have little income outside of the annuity payments. Were they U.S. citizens, even though the entire amount of the annuity payments (rather than just the accretion element) would theoretically be taxable to them, their total taxable income would be so low as to incur little, and probably no tax. For example, a lower paid agricultural worker in a nontreaty Latin American country, who is entitled to receive a $5,000 annual pension which he had earned by 30 years of labor, finds that his pension is reduced to $4,000 (or $333 per month instead of $417 per month)—an effective rate of tax of 20 percent.[5] In contrast, a U.S. citizen over age 65 who is entitled to receive a $5,000 pension (from a noncontributory plan) and files either a joint return or as a surviving spouse would pay no tax; filing as a single individual such a U.S. citizen would pay a tax of only $98—an effective rate of 2 percent.

The problem in the case of nonresident alien pensioners is compounded by the fact that the 30-percent tax is imposed only on an arbitrarily selected number of them, and in an essentially regressive manner. U.S. tax treaties with 23 countries exempt from the 30-percent withholding tax retirement annuity payments to residents of those countries. Moreover, section 871(f) arbitrarily exempts such payments to residents of non-treaty countries, provided the services were rendered outside the U.S. and no more than 10 percent of the participants in the qualified pension of profit-sharing plan are nonresident aliens. The result is that the tax is not paid by pensioners who reside in developed countries with which the U.S. typically has treaties, but is paid by pensioners who reside in less-developed countries with which the U.S. typically does not have treaties. Because wage rates, and therefore pensions, are much lower in the less-developed countries than in the developed countries, a further result is that the tax is paid only by lower income nonresident alien pensioners.

Reciprocity of pension exemption is not a relevant consideration with respect to developing countries, since few U.S. citizens or residents will receive pensions accumulated in these countries. Section 871(f) could be amended to end the burdensome and arbitrary taxation of pensions paid to aliens residing in developing countries, while requiring reciprocity in circumstances where U.S. citizens are likely to benefit—industrialized countries which are not parties to tax treaties with the U.S. The revenue cost to the U.S. of such an exclusion would be so minimal as not to be a consideration.[6]

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[3] *See* S. Rep. No. 1707, 89th Cong., 2d Sess. (1966).

[4] *Id.*

[5] About two-thirds of the pension is allocable to earnings of the qualified trust and is, therefore, subject to the 30-percent withholding tax.

[6] S. Rep. 96–684 estimates that such an exclusion would reduce revenue received in fiscal year 1980 by less than $1 million. In 1981 and succeeding years, the annual revenue reduction is estimated to be less than $5 million. S. Rep. No. 684, 96th Congress, 2d Session 48 (May 6, 1980).

On May 6, 1980, the Senate Finance Committee reported, as an amendment to H.R. 2492, a provision which would amend section 871(f) to eliminate withholding on pensions paid to certain nonresident alien pensioners.[7] The Senate provision would accomplish these goals by making the section 871(f) exemption from tax of pensions paid to a nonresident alien for services performed abroad available to an individual if (a) the country of residence of the individual grants a substantially equivalent exclusion to citizens and residents of the United States (who are not also citizens of the recipient's country of residence) or (b) the recipient's country of residence is a "beneficiary developing country" within the meaning of section 502 of the Trade Act of 1974.[8]

Mr. ROSTENKOWSKI. Are there any questions of the witness?

Mr. GUARINI. Mr. Chairman.

Mr. ROSTENKOWSKI. Mr. Guarini.

Mr. GUARINI. There are a few concepts that I would like to get straight.

There is a withholding tax of 30 percent on people who do earn money here; isn't that correct?

Mr. CHRISTIAN. There is a 30-percent withholding tax paid on fixed and determinable income such as interest and dividends. In the case of compensation paid to nonresident employees for services rendered abroad, those persons are not taxable in the United States and there is no withholding tax. The proposed amendment is merely a minor technical point to correct the erroneous result that under present law the part of a person's compensation for services rendered outside the United States which is received in the form of a pension payment is subject to withholding unless changed by treaty.

Mr. GUARINI. And that person would pay considerably less than the income tax that an American citizen would have to pay because they would be taxed up to 70 percent, isn't that correct, on the same items?

Mr. CHRISTIAN. No, sir; that is not true. On income for the rendition of services the maximum tax is 50 percent.

Mr. GUARINI. That is not on interest or dividends, that is on earned income and employment.

Mr. CHRISTIAN. Yes.

Mr. GUARINI. The fact is that they do pay more than an American citizen would pay so that there is a distinction between how we tax resident aliens and as to how we tax our own people?

Mr. CHRISTIAN. That is true, but the nonresident aliens at their income levels are being subjected to a greater tax than a person of the same income level in the United States would be subject to. That is covered in great detail in our written statement.

Mr. GUARINI. How do we handle these treaty terms regarding the pension? Do we have any provision for them at all, the people who work here for foreign corporations but are resident aliens here? Is there any treaty with regard to that?

Mr. CHRISTIAN. No; this relates only to people who are not resident aliens but are nonresident aliens and work solely outside the United States. This is not a question of aliens who worked in the United States.

Mr. GUARINI. Now, if you have an English corporation that is owned 100 percent by the American corporation, the people who are employees of that English corporation would have extended to them our pension laws because of the parent corporation being an American corporation?

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[7] H.R. 2492, 9th Congress, 2d session, § 407, as reported by the Senate Finance Committee (May 6, 1980).

[8] 19 U.S.C. § 2462 (1976), as amended by Trade Agreements Act of 1979, Public Law 96-39, § 1106, § 1111, 93 Stat. 311-313, 315-316.

Mr. Christian. No. That is not what is involved in the separate amendment that I am talking about. I think that may be related to what Mr. Cohen was saying.

Mr. Guarini. I heard something you referred to earlier.

Mr. Cohen. I think Mr. Christian is talking about a problem in which there are nonresident aliens who have worked abroad and who participate in pension trusts, for example, that are created and maintained in the United States and therefore have to be subject to U.S. ERISA pension rules. I think in Mr. Christian's case he is talking about persons who worked abroad, earned their compensation and their pension abroad but who draw their checks from an American trustee or an American trust.

The type of case that I have been discussing of that nature is, as in your illustration, one in which a British company would maintain a trust in the United Kingdom under its laws, and a question has been raised because its laws can differ from our own. The IRS has said that the costs of those pensions could not be taken into account for U.S. tax purposes unless the United Kingdom pension plan conforms to our ERISA rules, and it is not possible to conform both to foreign rules and domestic rules when they are in conflict, it is not possible to export our own concepts as to what companies should provide abroad by way of pensions for foreign employees. As the Treasury indicated today, it is appropriate for the companies to follow the practices that are in effect in those foreign countries. That is what our bill does.

Mr. Guarini. The uniformity in that foreign country, the subsidiary would have the pension funds extended whether it is a branch or an entity in that particular country.

Mr. Cohen. Yes.

Mr. Guarini. Is that the thrust of your remarks?

Mr. Cohen. Yes.

Mr. Guarini. That same person could end up with a situation where he could get two social security payments, could he not? Has there not been an extensive problem where people from a European country would claim a social security benefit under the laws of that country and still work here and be able to make a second social security claim because they paid into the pension funds here?

Mr. Cohen. I am sorry, I am not familiar with that. I know of the existence of the problem, Mr. Guarini, but I am not familiar with the details of it. Nothing in the bill that we were talking about deals with that particular problem. We are dealing only with the income tax aspects, and the provision that we are dealing with and which I was commenting about would relate to cases in which the employee works entirely abroad, and therefore it had not occurred to me that there would be any possibility of his claiming U.S. social security benefits.

Mr. Guarini. But it does happen and it has been the subject matter f a recent treaty between the United States and Italy. I think that nen we are talking about extending our pension laws what we ought do is have a full retirement picture of the individuals that we are lking about and it does seem very plausible because they have social curities plans in the two countries and at the same time have an extnded pension fund under the rules that you are suggesting. I only row that out because it is a part of a very complicated picture and es involve the retirement of these people we are trying to cover.

Do you have any comment on that, Mr. Abel?

Mr. Abel. The whole question of integration of social security among different nations is, as you indicated, a matter of great concern to all governments of the industrially developed world. Article 51—one of the major articles of the Treaty of Rome of 1951—addressed this issue for the members of the Common Market which at that time contained six European countries and at this time contains nine; and they have now got a system in place and it is working among the industrial countries which are with members of the Common Market—where you cannot get to double up.

If you work 10 years in country A, you are entitled to benefits of country A. If you work in country B you are entitled to benefits of country B. You get your pro rata share. You cannot double up under the system; it is a very complicated matter, and it seems to be working very, very well. It got conceived in 1951 and implemented in 1961. It covers all forms of social benefits, not just pensions, like family allowances and other kinds of socially desirable benefits.

The question of the double coverage of nationals is a very complex matter that involves national sovereignty. When countries have their citizens abroad and they are still looking to them as their citizens and so forth, then under the jurisdiction of the host government; they are also covered. There has been a great effort going on among companies, among public entities—including national governments—over the last 10 to 20 years to bring about the kind of treaty that was actually enacted in the case of Italy and the United States. I understand that there is now before the Senate, I guess, a similar treaty for Germany and the United States.

The long-term trend is clearly to address these socially mandated programs in a sensible, global way so that people are not pyramiding things because these programs cost so much and they are so necessary for the individual citizens, and all countries want to try to eliminate the possibility of abuse.

Our bill, however, addresses only the question of the benefits that are provided voluntarily or involuntarily by the employer in excess of the social security systems to which the employee may be entitled in the country where he is operating.

Mr. Guarini. I didn't want to overcompensate him.

Mr. Abel. I don't think that our bill would in any way make that possible.

Mr. Guarini. Thank you.

Mr. Rostenkowski. Thank you, gentlemen.

Mr. Maffin.

STATEMENT OF ROBERT W. MAFFIN, EXECUTIVE DIRECTOR, NATIONAL ASSOCIATION OF HOUSING AND REDEVELOPMENT OFFICIALS, ACCOMPANIED BY HOWARD FELDMAN AND RICHARD DUNNELLS, COUNSELS

Mr. Maffin. Thank you, Mr. Chairman.

My name is Robert W. Maffin. I am accompanied by counsels Howard Feldman and Richard Dunnells.

I serve as executive director of the National Association of Housing and Redevelopment Officials on whose behalf I testify today. Our association greatly appreciates the opportunity to present its views on H.R. 7276, a bill to amend the Internal Revenue Code to allow the investment tax credit for certain rehabilitated buildings leased to tax-exempt organizations and governmental units.

Our association is composed of State and local officials from all over the country who are engaged in the planning and redevelopment of urban areas. Our membership, totaling some 8,500 individuals and agencies, covers practically all urban areas in the United States. We speak on this isue with total unanimity today.

The stated purpose of the expansion of the investment tax credit to rehabilitated structures—to stimulate inner city rehabilitation—has been severely jeopardized by excluding from coverage such properties which are leased to governmental units and tax-exempt organizations. Not only are these entities unable to compete with private lessees for rental space but since governmental units and tax-exempt organizations are potentially substantial lessees of such property, the market uncertainty is already causing a curtailment in the rehabilitation of structures. This result is the exact opposite of what the new tax credit was intended to accomplish.

H.R. 7276 would rectify this situation.

As the law now stands, lessors who lease rehabilitated structures to governmental units or tax-exempt organizations cannot obtain the investment tax credit. As such, they must charge higher rents to such entities than would be charted to private lessees. It is clear, therefore, that existing rehabilitated space will be leased to the private sector.

Governmental units and tax-exempt organizations have always been disproportionately high users of inner-city properties because of their need to be in proximity to the public they serve. Often these same Government agencies and tax-exempt organizations have been instrumental in initiating, encouraging or directly asssisting in the redevelopment of older, declining neighborhoods and in the renovation of their older buildings. There are literally hundreds of examples where Federal, State or local government agencies or tax-exempt organizations have manifested their commitment to the redevelopment of declining neighborhoods and to the renovation of older buildings by locating and leasing in such neighborhoods and buildings.

This commitment by Government agencies and the tax-exempt organizations to locate and lease in such neighborhoods and renovated buildings has not only proven to be a catalyst for private investment but in many instances has broken the barrier of private sector resistance to locate and lease in such neighborhoods and buildings. It is precisely this type of relocation and leasing action by Government agencies and tax-exempt organizations that has caused individual buildings, declining neighborhoods and central city areas to "turn around" through the infusion of private investment capital and pri- ate interest.

To impede or restrict the stimulus of Federal, State, or local govern- nent agency and tax-exempt organization leasing and relocation to enovated buildings in such neighborhoods or areas is clearly contrary o congressional intent.

Moreover, in the case of governmental units, statutes place limits n the amount of rent which they are permitted to pay. For example, ne Economy Act of 1932 [40 U.S.C.A. section 278(a)], which can never be waived, establishes a maximum rental formula for lease agreements to which the Government is a party. Under this formula the Government generally is required to pay less than private lessees. To render the Government noncompetitive in its search for leased space in the inner city would severely impact on its ability to obtain space at reasonable rates while assisting in urban revitalization. Under present conditions therefore, private capital is already hesitating to venture into proposed rehabilitation projects in inner city areas because a large segment of the leasing market has been eliminated through the denial of the investment tax credit.

It is doubtful that such a situation was envisioned or intended upon passage of the rehabilitation investment tax credit in 1978. The denial of the investment tax credit in situations involving governmental units and tax-exempt organizations stems from restrictions imposed on such entities in preexisting law which dealt solely with investment tax credits for equipment and other personal property. The expansion of the investment tax credit to real property brought about, for the first time, the interplay between the investment tax credit and complex real estate leases.

Eliminating the tax credit attributable to rehabilitated property which was leased on a net lease basis did not make sense; yet such was the result when the rehabilitation investment tax credit was enacted in 1978 because of the applicability of existing definitions used for the personal property investment tax credit. Recognizing the difference in the two situations, Congress rectified this problem by passing, as part of the Technical Corrections Act of 1979 [Public Law 96–222, April 1, 1980], an amendment to the code which provided that the availability of the rehabilitation investment tax credit will not be affected by the fact that the property is leased on a net lease basis. As the Senate report to H.R. 2797 notes:

> The application of the noncorporate lessor limitation will deny the investment tax credit in many situations where the taxpayers have incurred substantial expenditures in rehabilitating older buildings. This restriction will cause an unintended diminution in the impact of extending the credit to rehabilitated buildings, particularly in urban areas where older buildings are presently vacant and make no contribution to the area's economic base. [S. Rep. 96–498, December 13, 1979.]

The same reasoning is clearly applicable to rehabilitated buildings leased by governmental units or tax-exempt organizations. The continued discrimination against these entities will cause an unintended diminution in the rehabilitation of buildings.

Accordingly, it is submitted that the rehabilitation investment tax credit should be amended to apply to rehabilitated structures which are leased by governmental units and tax-exempt organizations. H.R. 7276 is narrowly drawn to limit the expansion of that credit to situations where such entities are lessees, not owners, so as to prevent the possibility of tax-exempt moneys financing a project with the tax credit sold to a private lessee. The amendment should be made retroactive to the passage of the rehabilitation investment tax credit, as was done in the case of the net lease amendment.

The revenue impact should be minimal. In fact, it is our understanding that, in making its original estimate of revenue loss in 1978, the Treasury did not differentiate on the basis of lessees; accordingly, Treasury's original figures may have included any revenue loss attributable to property which would be subject to such leases.

In summary, the rehabilitation investment tax credit should be made available to lessors who lease to governmental units and tax-exempt organizations as well as to private parties. Extension of the credit would permit these entities to seek office space on a competitive basis and would also stimulate the flow of private capital to rehabilitation projects in inner city areas. Denial of the credit would place the Government in the anomalous situation of subsidizing the private sector while denying itself the identical benefit needed to compete for the limited office space now on the market.

Thank you, Mr. Chairman and members of the committee, for the opportunity to testify. I would be pleased to try to answer any questions you may have.

Mr. **Rostenkowski.** No questions.

Mr. **Guarini.** Do you have any idea of the cost which would be incurred by the U.S. Government as a result of the passage of H.R. 7276?

Mr. **Maffin.** I believe, sir, as our comments indicated we have no precise figures of that kind. We are under the impression that Treasury originally included those sums in calculating losses arriving from the amendments of 1978.

Mr. **Guarini.** It would be considerable though, would it not?

Mr. **Maffin.** May I check for just a moment?

Mr. **Guarini.** Let's move on.

The tax exempt definition varies from State to State, does it not, and these will be an uneven application of the law in that instance?

Mr. **Dunnells.** We are thinking in terms of keying it to the Internal Revenue Code Section 501, tax exempt under the Internal Revenue Code for Federal purposes.

Mr. **Guarini.** Well, that section concerns contributions whereas tax exempt property for real estate purposes would have a different definition from the State's view and the States have sovereignty over that portion of tax law dealing with real estate. I think that the definition of accepance by State governments would be different than the Federal Government's and each State's would be different from one anothers.

Mr. **Dunnells.** Our intention in this bill would be to promote the ax credit for a lessor who leases to a tax exempt organization which would be also defined in the code under section 501 of the Internal Revenue Code. I understand your point, Congressman.

Mr. **Guarini.** Isn't the trend in many of the States to try to minimize the tax-exempt organizations impact on real estate taxes, especially in some of the large cities. Isn't real estate owned and run by tax-exempt corporations a burden on the municipalities, especially in the nner cities?

Mr. **Feldman.** Congressman, if I understand your question, I think he trend you are referring to would be tax-exempt organizations hich are the owners of real property. This proposed amendment ould deal only with tax-exempt organizations as lessees, as tenants f commercial office buildings.

Mr. GUARINI. I understand that property that is both owned by and leased by is included in the bill. Is that not correct, according to my understanding of the statement of the Treasury before me?

Mr. DUNNELLS. No. Our use is just limited to property leased by the tax-exempt organization or the governmental units. We did not want to get into a situation whereby, as noted in the statement, a tax exempt organization could in effect sell the tax credits so we had that very narrowly defined, Congressman.

Mr. GUARINI. Now does this affect the cost of real estate to the governmental body or to the tax-exempt institution if it is leasing?

Mr. FELDMAN. Congressman, it is our view that this would assist governmental units and tax-exempt organizations in obtaining lower rentals from the owners of rehabilitated buildings for the simple reason that an owner or developer of real property looks at the combination of cash flow from rents plus various tax benefits which would inure to the ownership of the property. If that tax benefit is to the owner of the property because of the unavailability of the investment tax credit in the case of leasing to tax exempt or governmental entities, that owner, lessor, will make one of two decisions: Either not to lease to the tax exempt or governmental entity or demand a higher rent from that tax exempt or governmental entity.

Mr. GUARINI. Isn't the law of the marketplace as simple as supply and demand? You would be giving an extra tax credit to a real estate investor.

Mr. FELDMAN. Sir, that is always the case. There is always that variable in the marketplace but certainly in the context of the Washington, D.C., market, for example, and also speaking hypothetically I think the point I make is a sound one that return from real estate investment is a function of cash flow and tax benefits. If that tax benefit is denied the owner through governmental action, he either will not lease to a tax exempt or governmental entity or increase the dollar rental for the space.

Mr. GUARINI. Real estate is the best tax shelter we have. The owner has great incentive as it is. I accept the fact that in inner cities we have depreciated property and blighted areas but I just don't know why there is a need for this kind of bill. How much of the tax incentive can it be proven would go to rehabilitating some of our inner cities? I would like for you to comment.

Mr. ROSTENKOWSKI. Would the gentleman yield?

Mr. GUARINI. Yes.

Mr. ROSTENKOWSKI. This is an amendment to legislation that we passed in 1978 where the committee was concerned whether or not the investment would stay in the city. I think that was the original intent of giving the 10-percent investment credit for rehabilitation. I remember on State Street in Chicago that had the local merchants not had this credit, I am sure that the improvements of the outer stretch of the buildings would not have taken place.

Mr. GUARINI. This would apply to Hyde Park, N.Y.; La Jolla, Calif.; or Short Hills, N.J. I don't know that we should help the situation in those areas.

Mr. ROSTENKOWSKI. The buildings would have to be 20 years old or older.

Mr. **Maffin**. From the viewpoint of our association, Congressman, one of the principal things that we look at is what effect is this going to have on the configuration of the city. Many of these older buildings, as the statement indicates, have stood in declining condition for a number of years. The changing function of the city as well as the historical function of the city indicates that among the prime potential users of that space are nonprofit entities, governmental offices, and some of them are already there and they need room for expansion or modification of existing space.

From our point of view the essential feature of this proposed amendment is when buildings are rehabilitated that these kinds of users are equally attractive as lessees on the part of the developer or the person who rehabilitates the property so that those kinds of uses which are critical to the central city are equally attractive as some other kind of user and it is from that standpoint that we tend to look at the benefits of this particular amendment.

Mr. **Guarini**. If the inner cities have blighted areas, how is this bill going to aid them?

Mr. **Maffin**. What this does is recognize a market fact and that is in a reality of the central city that many of the people, many of the institutions and space users in the center city are the governmental entities and nonprofit organizations. The impact of retaining the amendment as it stands is to discourage the continued use of those renovated spaces because the same attractive return is not provided when they lease to governments and nonprofit entities as they do to private sector people.

Mr. **Guarini**. Just so that I am clear, isn't it true that the 10-percent tax credit for blighted areas already exists as part of our tax law?

Mr. **Maffin**. That is not my understanding. I could be corrected on that matter. It is my understanding that the legislation applies to buildings that may be located anywhere. The fact of the matter is that more older buildings are located in the central city but it does not apply to cities.

Mr. **Dunnells**. It is on the books for all rehabilitation within the definition. It excludes governmental units and tax exempt organizations because of preexisting definitions in the code who are users of these buildings.

Mr. **Guarini**. Therefore, what you want to do is put this on the same level and equate it with the existing law?

Mr. **Dunnells**. Correct. So that they are not penalized. So what we find happening is that you prelease many of these buildings. In other words, you are going to go in and renovate if you have the lessee. Many of them are tax-exempt organizations. A lot of these renovations won't even be done because many of the private corporations would not want to be in this rehabilitation area so we are penalizing the whole renovation of the area and we are penalizing the users, we believe, who would use these buildings.

Mr. **Guarini**. The thrust of your bill would not be in the suburban areas but would be toward the same areas for which we presently give the 10-percent tax credit in order to stimulate commercial property today.

Mr. **Dunnells**. That is correct.

Mr. MAFFIN. That is absolutely correct.

Mr. DUNNELLS. I am not saying it is not used in suburban areas. There may be buildings that qualify.

Mr. ROSTENKOWSKI. That is what the committee considered 2 years ago. You are talking about retroactivity in this legislation. How would you feel about making it perspective as only? Why should we be giving a windfall incentive to people who have already rehabilitated?

Mr. DUNNELLS. The net lease amendment, Mr. Chairman, was made retroactive and I think it was made retroactive because of people who commenced projects after the bill was passed and there was probably work in progress when they were working on their project. I don't know the status of how many of these buildings there are at this particular time.

Mr. GUARINI. Would the Chairman yield?

Mr. ROSTENKOWSKI. Yes.

Mr. GUARINI. Would that not create a windfall?

Mr. ROSTENKOWSKI. The retroactivity?

Mr. GUARINI. Yes; because the lease is negotiated in terms of existing circumstances. If you are going to then roll back the tax credit there is going to be an extra sum of money that the owner of the property will have that he never thought about when he negotiated the lease in the first instance.

Mr. MAFFIN. May I comment on that. It seems to me there is a marginal benefit and public benefit to the retroactivity feature in the following sense: many government agencies and many nonprofit institutions are now looking for rented space in the central city. Some buildings have been rehabilitated but have not been leased up fully. By allowing a retroactive feature to the legislation, the opportunity is opened for that governmental entity or that nonprofit organization and that owner of rehabilitated property to enter into a more favorable lease in my judgment to the nonprofit organization or to the governmental entity.

Mr. GUARINI. In the future lease, not the existing lease.

Mr. MAFFIN. That is right, the future lease. That would be my understanding. It would be a future lease but it would apply to a building that has already been rehabilitated.

Would that be your understanding?

Mr. DUNNELLS. Yes.

Mr. ROSTENKOWSKI. The time of the gentleman has expired.

Mr. Duncan.

Mr. DUNCAN. I have no questions.

Mr. ROSTENKOWSKI. Thank you, gentlemen.

The Hon. Albert Gore from Tennessee.

STATEMENT OF HON. ALBERT GORE, JR., A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TENNESSEE

Mr. GORE. Thank you very much, Mr. Chairman, and my colleague from Tennessee. Let me thank you for allowing me to testify at this time. I am appearing out of turn and I appreciate it very much.

It is a pleasure to appear before you today to discuss H.R. 7520, a bill designed to preserve the tax-exempt status of rural electric and telephone cooperatives. H.R. 7520 is a slightly narrower version of

H.R. 5643 which I introduced last year and which was cosponsored by 130 of my colleagues. I want to commend Chairman Ullman for the work and guidance he has provided in redrafting my original bill. His expertise and his support on this important issue are greatly appreciated.

Electric and telephone cooperatives are the backbone of rural America. Congress helped nurture the growth of co-ops in the 1930's and 1940's in order to improve the quality of life in rural areas. Privately owned utilities brought necessary services to urban centers, but they either could not or would not furnish the needs of rural areas.

The goal of cooperatives is not to make profits but to bring reliable service at the lowest possible price. This is one of the principal reasons why we have seen co-ops on the forefront of major technological changes and innovative, cost-cutting measures.

There are more than 1,000 electric co-ops in this country in 46 States. They provide service to 25 million people and cover more than 50 percent of the land area in the United States. Telephone co-ops operate in 30 States and provide telephone service to more than 750,000 people. Co-ops are an indispensable part of rural life and continue to provide opportunities for growth and development.

Unfortunately, it seems that the Internal Revenue Service does not share the enthusiasm of Congress for cooperatives. Recent technical advice memoranda by the IRS have attempted to chip away at their tax-exempt status and have placed unnecessary and unreasonable burdens on cooperatives. The IRS memorandums have said that income from pole rentals and display listings in "Yellow Page" directories is unrelated business income and therefore taxable.

The IRS actions have two adverse implications for co-ops. First, co-ops will be required, for the first time, to pay taxes on this type of income. In Tennessee, our 22 electric cooperatives could have to pay as much as $800,000 in additional taxes from pole rental income. Similar costs can be expected from other States. While this may not add up to a large tax revenue for the IRS, it is the type of unnecessary cost which causes electric rates to soar.

Second, and more importanty, these IRS rulings could jeopardize the tax-exempt status of co-ops altogether. Under present law a rural electric or telephone cooperative is tax exempt provided that 85 percent or more of its income consists of amounts collected from members for the sole purpose of meeting losses and expenses. If the IRS position is allowed to stand, many co-ops may be faced with losing their tax-exempt status. Worse still, if an electric cooperative is in danger of reaching the 15-percent limit because of pole rental income; it may be forced to tell the telephone cooperative to build its own poles. Imagine the esthetics, to say nothing of the stupidity, of having two poles side by side, one providing electricity and one providing telephone service.

The IRS technical advice memorandum on pole rentals argues that the leasing of space on utility poles does not have a substantial causal relationship to the achievement of the exempt purpose of the cooperative. I believe that, even in the absence of this legislation, a strong case can be made that this ruling is erroneous. And on the face of it, the ruling strains simple logic.

Leasing pole space is integrally related to the purpose of cooperatives. The purpose of electric cooperatives, as seen by the legislativ history of the Rural Electrification Act, is to promote the public good by providing area service to the largest number of people at the lowes possible cost. To effect this purpose, REA has urged co-ops to ente into reciprocal agreements for the joint use of poles. The legislativ history of the 1949 amendments to the Rural Electrification Act i replete with expressions of congressional intent to cut costs by encouraging joint pole use.

The purpose of joint pole use is to eliminate duplication, to reduc maintenance expenses, to promote sound engineering practices, and t reduce the need to obtain new rights-of-way. All of this is precisel within the purpose REA and Congress envisioned for cooperatives.

However, the issue becomes clouded because Congress did not enac the first unrelated business income tax until 1950, and cooperative were not subject to it until 1969. Thus, IRS can correctly argue tha Congress did not speak to this precise point despite the fact tha the intent to encourage joint pole use is very clear.

Yet by looking to the policy behind the unrelated business incom tax, there is further evidence that pole rentals should not be included The tax was designed to prevent unfair competition with taxable businesses. The IRS, for example, would argue that money gained at church supper is taxable because the church is in competition wit the local restaurant. But there is no such competition with utilit poles. Once one set of poles is erected, all other utilities will want t share that pole, not build one of their own.

I regret that IRS, in my opinion, misconstrued the congressiona intent in its recent technical advisory opinions. Unfortunately, Congress must now reaffirm its intent to exclude pole rentals and displa listings from unrelated business income definitions. Otherwise, co-op around the country are going to have to dig into their pockets an ultimately increase rates to consumers.

I applaud IRS efforts to tighten tax laws but I am afraid thei efforts in this area are totally misguided. Enactment of this bill wil not provide any revenue loss to the IRS because very little, if any money has been collected yet. However, if this ruling is allowed t stand, it will ultimately be translated into significant costs for co-op and it will frustrate their efforts to meet the needs of their customers.

On behalf of the 130 cosponsors of my original bill and the man supporters of the revised bill, I urge this subcommittee to act favorabl on this important measure. Thank you again, Mr. Chairman, for th opportunity to present my views.

Mr. Rostenkowski. Thank you, Mr. Gore.

Mr. Duncan.

Mr. Duncan. I want to welcome my colleague to the committee an thank you for the excellent statement.

It has to be a good bill because I am one of the cosponsors. I hop we favorably report it. Your help and your statement will certainly b used beneficially by all the committee.

Thank you.

Mr. Rostenkowski. Mr. Gore, to add real strength to your legislation I am going to yield to the gentleman from Texas, a member o the full committee.

Mr. Pickle.

Mr. PICKLE. I will abide by our general agreement, Mr. Chairman. As a cosponsor of this measure I am glad you appeared and testified. I think you presented the case well.

Mr. ROSTENKOWSKI. Thank you very much, Mr. Gore.

Mr. GORE. I like the way the subcommittee does business, Mr. Chairman. Thank you very much.

Mr. ROSTENKOWSKI. Thank you.

Mr. Hershson, Mr. Pearlman and Mr. Schultz.

Welcome to the committee, gentlemen. We will hear you in the order in which I called you. Mr. Hershson, if you will begin, followed by Mr. Pearlman and Mr. Schultz.

STATEMENT OF MORRIS HERSHSON, PRESIDENT, THE NATIONAL BARREL AND DRUM ASSOCIATION

Mr. HERSHSON. I thank you, Mr. Chairman and the members of this subcommittee, for giving us this opportunity to present our views.

In the interest of brevity, and with your permission, I would insert two statements and then Mr. Pearlman and Mr. Schultz will each make a statement. I would like to insert as well an analysis of the bill which we have prepared, an energy study and statements made before the Subcommittee on Transportation and Commerce on March 4, 1980.

Mr. ROSTENKOWSKI. The Chair will allow the statements to be entered in the record. How long is that statement?

Mr. HERSHSON. The analysis is about 15 pages.

Mr. ROSTENKOWSKI. We will make that available in the record.

Mr. HERSHSON. Thank you.

My name is Morris Hershson. I am president of the National Barrel & Drum Association which is the single voice of the steel drum reconditioning industry. The association includes about 80 percent of all reconditioners in this country and about 85 percent to 95 percent by volume of the total national production.

I am here today to voice the industry's support for H.R. 7487 which would place an excise tax on the sale of lighter gage steel containers. The effect of this legislation is to encourage the use of heavier gage, reconditionable drums of 55 gallon size. It does so by discouraging the purchase of lighter gage containers that do not stand up to the rigor of use and reuse to the degree a heavier 18-gage drum will. It is interesting to note the Department of Transportation has found that the 18-gage drum is a safer drum for transportation.

The problem addressed by this bill is the growing scarcity of reconditional drums. Without a sufficient supply of these drums the reconditioning industry cannot survive. This problem has grown over the years until, at present, lighter gage drums dominate the market.

We have reached a critical threshold in the supply of used drums. Users of the returnable drum system are switching to lighter drums. Citgo, Exxon, Witco, Shell, and Gulf have changed or are considering changing to lighter drums, some being single-trip, throwaway drums.

Why should Congress intervene? Opponents of this measure may argue that manufacturers profit from growing production and that the purchaser enjoys a lower initial price for a lighter drum.

This false reasoning jeopardizes the free-market hazardous was
collection system provided by the reconditioner. A drum when emptie
typically contains a residue of 1 or 2 gallons. In total, the recondition
ing industry receives 45 million drums a year and disposes of 50
100 million gallons of industrial waste, much of these wastes bein
hazardous. When he receives an empty drum, the reconditioner acts
a safe and experienced market agent in handling its residual waste

EPA has recognized the status of our industry and its contributio
They have exempted drums containing such residues as highly tox
pesticides from the operations of RCRA knowing that we collect an
consolidate such wastes and deliver them to secure land fills or trea
ment facilities.

Where does a lighter gage drum go; where can it go? It might
sent to a scrap yard but the scrap dealer does not wish to purchase
drum with substances he does not know how to deal with, and whic
substances may contaminate scrap piles. It might also go to a deal
in wastes. This alternative, too, presents its problems.

The effect of a lighter gage drum system is to place drums contai
ing hazardous wastes in the hands of scrap and waste dealers wh
have 30 times the rate of serious and willful violations of OSHA
hazardous materials regulations when compared to the reconditioner
Penalties levied on these dealers for these offenses are 250 times high
when compared to the reconditioners.

The irony of the present situation is that the scarcity of used drun
is forcing the reconditioner, against his own economic interest, to pu
chase used throwaway drums in order to obtain some heavier ga
drums that an emptier may possess.

Will lighter gage drums cause the inevitable decline of the reco
ditioning industry? The answer is yes. We are not dealing with o
type of lighter drum. Each new type introduced is lighter than t
last. The shift is progressive. Some heavy gage drum production w
remain, perhaps, but it will not support a reconditioning industr

Will H.R. 7487 accomplish its purpose? This bill will restore an
maintain a balanced system of new and reconditioned drums. It w
preserve the waste management service provided by the reconditione
Because reconditioning requires less energy and materials, H.R. 74
will cause about a 10-percent reduction in energy consumed in t
entire process and will result in about 15-percent material saving

The bill will cause no significant harm to the manufacturer. Det
mental employment impacts on the manufacturer will be minim
while beneficial employment impacts for the reconditioner will
significant.

The drum purchaser will pay only 4 cents more per gallon to sh
products that typically sell for over $10 a gallon. However, the high
salvage value of the heavier drum in comparison to the lighter dru
which has virtually no value, more than compensates for this 4-ce
increase. The bill thus has no significant inflationary impact.

For those purchasers of the lightest gage drum used to carry no
hazardous materials, they will be able to purchase reconditioned drum
The scarce supply of heavy gage drums today has caused reconditione
drum prices to rise; greater availability will cause prices to fall to
level at which these purchasers will benefit. There will be no shift

other drum materials, such as plastic drums, since the price of a reconditioned drum will be competitively low.

Should Congress encourage this system of hazardous waste collection, a system that conserves both natural resources and energy, which is offered by the reconditioner? We believe there is a compelling need for Congress to act. Drums containing hazardous residues in the hands of the inexperienced are a genuine problem. If the reconditioning industry fails, there will be no collection system for 45 million drums containing industrial wastes. We believe that society should take into account the cumulative costs and risks associated with the manufacture, transportation, and disposal of drums that often contain hazardous substances. H.R. 7487 proposes to impose a possible small cost in return for a large social gain to achieve such ends. We urge you to pass H.R. 7487.

Thank you, Mr. Chairman.

[The prepared statement and analysis follow:]

STATEMENT OF MORRIS HERSHSON, PRESIDENT, THE NATIONAL BARREL AND DRUM ASSOCIATION

My name is Morris Hershson. I am president of the National Barrel and Drum Association, which is the single voice of the steel drum reconditioning industry. The Association includes about 80 percent of all reconditioners in this country and about 85 percent to 90 percent by volume of the total national production.

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The problem addressed by this bill is the growing scarcity of reconditionable drums. Without a sufficient supply of these drums the reconditioning industry cannot survive. This problem has grown over the years until, at present, lighter gauge drums dominate the market.

We have reached a critical threshold in the supply of used drums. Users of the returnable drum system are switching to lighter drums. Citgo, Exxon, Witco, Shell, and Gulf have changed or are considering changing to lighter drums, some being single trip—throwaway drums.

Why should Congress intervene? Opponents of this measure may argue that manufacturers profit from growing production and that the purchaser enjoys a lower initial price for a lighter drum.

This false reasoning jeopardizes the free-market hazardous waste collection system provided by the reconditioner. A drum when emptied typically contains a residue of one or two gallons. In total, the reconditioning industry receives 45 million drums a year and disposes of 50 to 100 million gallons of industrial waste, much of these wastes being hazardous. When he receives an empty drum, the reconditioner acts as a safe and experienced market agent in handling its residual wastes.

Where does a lighter gauge drum go; where can it go? It might be sent to a scrap yard, but the scrap dealer does not wish to purchase a drum with substances he does not know how to deal with, and which substances may contaminate scrap piles. It might also go to a dealer in wastes. This alternative, too, presents its problems.

The effect of a lighter gauge drum system is to place drums containing hazardous wastes in the hands of scrap and waste dealers who have 30 times the rate of serious and willful violations of OSHA's hazardous materials regulations when compared to the reconditioners. Penalties levied on these dealers for these offenses are 250 times higher when compared to the reconditioners.

The irony of the present situation is that the scarcity of used drums is forcing the reconditioners, against his own economic interest, to purchase used throwaway drums in order to obtain some heavier gauge drums that an emptier may possess.

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Will lighter gauge drums cause the inevitable decline of the reconditioning industry? The answer is yes. We are not dealing with one type of lighter drum. Each new type introduced is lighter than the last. The shift is progressive. Some heavy gauge drum production will remain perhaps but it will not support a reconditioning industry.

Will H.R. 7487 accomplish its purpose? This bill will restore and maintain a balanced system of new and reconditioned drums. It will preserve the waste management service provided by the reconditioner. Because reconditioning requires less energy and materials, H.R. 7487 will cause about a 10 percent reduction in energy consumed in the entire process and will result in about 15 percent material savings.

The bill will cause no significant harm to the manufacturer. Detrimental employment impacts on the manufacturer will be minimal while beneficial employment impacts for the reconditioner will be significant.

The drum purchaser will pay only four cents more per gallon to ship products that typically sell for over ten dollars a gallon. However, the higher salvage value of the heavier drum in comparison to the lighter drum more than compensates for this four cent increase. The bill thus has no significant inflationary impact.

For those purchasers of the lightest gauge drum used to carry non-hazardous materials, they will be able to purchase reconditioned drums. The scarce supply of heavy gauge drums has caused reconditioned drum prices to rise; greater availability will cause prices to fall to a level at which these purchasers will benefit. There will be no shift to other drum materials, such as plastic drums, since the price of a reconditioned drum will be competitively low.

Should Congress encourage this system of hazardous waste collection, a system that conserves both natural resources and energy, which is offered by the reconditioners? We believe there is a compelling need for Congress to act. Drums containing hazardous residues in the hands of the inexperienced are a genuine problem. If the reconditioning industry fails, there will be no collection system for 45 million drums containing industrial wastes. We believe that society should take into account the cumulative costs and risks associated with the manufacture, transportation, and disposal of drums that often contain hazardous substances. H.R. 7487 proposes to impose a small cost in return for a large social gain to achieve such ends. We urge you to pass H.R. 7487.

[An analysis of H.R. 7487 follows. Supporting materials also submitted are retained in the subcommittee legislative files.]

[From the Congressional Record, June 4, 1980]

EXCISE TAX ON LIGHTER GAGE STEEL DRUMS

Mr. GUARINI. Mr. Speaker, today I am introducing a bill which would amend the Internal Revenue Code of 1954 to impose a manufacturer's excise tax on the sale of light-gage steel drums.

Specifically, my bill would impose a tax equal to 20 percent of the selling price when a drum with a capacity of 35 to 65 gallons and made of steel lighter than 18 gage is sold by a manufacturer, producer, or importer. The purpose of my bill is to encourage the production, purchase, and use of heavy-gage steel drums which can be reconditioned for subsequent use. This will result in substantial energy and materials conservation as well as bolstering an existing system for the collection and disposal of hazardous and nonhazardous industrial materials.

The linchpin in this collection-and-disposal system is the steel drum reconditioning industry. This nationwide network handled 45 million drums last year and collected more than 50 million gallons of residual industrial materials which remained in the drums prior to reconditioning. However, the continued existence of the drum reconditioning industry is dependent upon the availability of drums which can be reconditioned. Heavy-gage steel drums can be put through the process nine or more times while light gage drums can be reconditioned only two or three times. The very lightest gage drums cannot be reconditioned at all.

In recent years there has been a serious decline in the national inventory of reconditionable steel drums because of the greater reliance upon light-gage drums. In 1939, heavy-gage steel drums comprised approximately 82 percent of new production. Today, 18-gage drums account for only 45 percent of new production and a continued decline in production is projected.

Although light-gage steel drums cannot endure the rigors of reconditioning, the attraction of the light drum is its lower initial cost, presently averaging $16.65 per drum compared to $18.65 per drum made of heavy-gage steel. The tax I am proposing would increase the cost of the light drum to approximately $19.98.

There are several important benefits to be derived from encouraging the continued production of heavy-gage steel drums.

First, there is already in place a nationwide network of drum reconditioners who act as centralized collecting points for both hazardous and nonhazardous materials. Without this system, drums will be less likely to be reconditioned and empty drums may well fall into the hands of those who are unable or unwilling to properly dispose of them.

Alternate methods of disposal are not readily avialable. Burial in landfills is not feasible because of limited space available. The impact of 45 million drums annually on existing landfills would be severe.

Even as scrap, unreconditioned drums are not desirable because of the possibility that they might contaminate other scrap materials with toxic or corrosive chemical residues.

The increased incidence of midnight dumping of chemicals and drums would only be enhanced if drum reconditioning is not available. Recent news articles document that such activities are extremely costly. In North Carolina, one such incident along 200 miles of highway cost the State approximately $6 million for cleanup, required the destruction of crops bordering the roadways where the dumping occurred, and jeopardized the health of residents.

Aside from the environmental aspects ,a second significant benefit is energy conservation. It requires 10 times more energy to manufacture a new drum than to recondition an old one. This is not insignificant in light of the 45 million drums reconditioned annually.

Finally, drum reconditioning is important to materials conservation. Each year, the reconditioning industry recycles 1 million tons of steel. Put in perspective, this is the equivalent of 17 George Washington bridges.

Quite deservedly, America has earned the reputation of being a nation which needlessly wastes the resources which others would conserve and recycle. This has not always been our tradition, however. During World War II, the purchase of new steel drums was prohibited unless the user had reconditioned his supply of drums as many times as possible. This commonsense approach necessitated by wartime can certainly be applied to the crisis we face today in managing our resources, saving energy, and preserving our environment and I call upon my colleagues to support this proposal.

[H.R. 7487, 96th Cong., 2d sess.]

A BILL To amend the Internal Revenue Code of 1954 to impose a manufacturers excise tax on the sale of light gauge steel drums

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) chapter 32 of the Internal Revenue Code of 1954 (relating to manufacturers excise taxes) is amended by inserting after subchapter B the following new subchapter:

"SUBCHAPTER C—LIGHT GAUGE STEEL DRUMS

"Sec. 4131. Imposition of tax.

"SEC. 4131. IMPOSITION OF TAX.

"(a) TAX IMPOSED.—There is hereby imposed on the sale by the manufacturer, producer, or importer of each light gauge steel drum a tax equal to 20 percent of the price for which so sold.

"(b) LIGHT GAUGE STEEL DRUM.—For purposes of this subchapter, the term 'light gauge steel drum' means any drum—

"(1) the body of which is of steel sheet lighter than 18 gauge, and

"(2) which has a liquid capacity of at least 35, but not more than 65, United States gallons."

(b)(1) Subsection (a) of section 4218 of such Code (relating to use by manufacturer or importer considered as sale) is amended by inserting "or any light gauge steel drum taxable under section 4131" after "under section 4121".

(2) Subsection (a) of section 4221 of such Code (relating to certain tax-free sales) is amended by striking out "section 4121" and inserting in lieu thereof "sections 4121 and 4131".

(3) Section 4293 of such Code (relating to exemption for United States and possessions) is amended by striking out "and 4121" and inserting in lieu thereof ", 4121, and 4131".

(4) Paragraphs (2) and (3) of section 6416(b) of such Code (relating to special cases in which tax payments considered overpayments) are amended by inserting "or any light gauge steel drum taxable under section 4131" after "section 4121".

(c) The table of subchapters for chapter 32 of such Code is amended by inserting after the item relating to subchapter B the following new item:

"SUBCHAPTER C. Light gauge steel drums."

(d) The amendments made by this Act shall apply with respect to sales after the 180th day after the date of the enactment of this Act.

AN ANALYSIS OF H.R. 7487

SUMMARY

Purpose

H.R. 7487 proposes to place a manufacturers excise tax of 20 percent on the sale of steel drums lighter than 18 gauge. Its purpose is to encourage the use of heavier gauge steel drums that may be beneficially reconditioned and returned to use.

The reconditioning industry provides the public with important benefits by acting as a safe and experienced market agent for the collection and disposal of the hazardous residues that remain in the drum after use. In addition, reconditioning conserves both energy and materials.

Congress should concern itself with the future of the drum reconditioning industry, because its demise would require the federal government to re-invent it so critical are the functions carried out by the industry. Without the reconditioner, the nation would have to find disposal for 70 million drums a year and their chemical residues.

Advantages of H.R. 7487

H.R. 7487 is revenue producing; yet the tax is self-canceling as buyers shift to the purchase of heavier drums. It entails low administrative costs, since the bill affects a small group of manufacturers. H.R. 7487 avoids short-term market disruptions through a 180 day grace period.

The bill would cause no significant adverse impacts on the manufacturer. H.R. 7487 causes few, if any, employment problems for the manufacturer while having beneficial affects on the reconditioning industry. It results in no production-related difficulties. Moreover, it has no inflationary side-effects since the tax adds only 4 cents per gallon to the price of products that typically sell for $10 a gallon.

Most importantly, H.R. 7487 will achieve its purpose in restoring the use of heavy gauge, reconditionable drums in a market that has been captured by lighter gauge steel containers that are, in many instances, throw-aways.

INTRODUCTION

H.R. 7487 would impose a twenty percent manufacturers excise tax on the sale of steel drums lighter than 18 gauge. Its purpose is to encourage the purchase and use of heavier gauge drums that can be beneficially reconditioned. Reconditioning steel drums permits a conservation of materials, a saving of energy, and most importantly, reduces environmental risks. The reconditioning industry acts as a safe and experienced market agent for the collection and disposal of drums containing hazardous residues for which only limited other disposal alternatives exist. This industry depends on an ample supply of heavy gauge, reconditionable drums. The harm of lighter gauge drums is that they are, in many instances, throw-away containers that cannot be reconditioned. The lighter gauge drum has captured the market place and is causing inevitable decline for the reconditioning industry. H.R. 7487 will ensure the continuation of the public benefits that flow from the reconditioner's service.

H.R. 7487 is well-targeted, and revenue-producing; yet it is also designed to be self-canceling and to avoid market disruption.

The tax is placed on the manufacturer, a small group if less than 200 companies. Thus, few administrative costs will result. It raises revenues in its initial phases as some buyers purchase lighter drums. The tax cancels itself as buyers purchase heavier drums to avoid the unnecessary payment of a tax—the buyer simply substitutes by purchasing heavier drums. Tax revenues will thus fall over the long term as a heavier gauge drum system is established.

The measure avoids short-term market disruptions. A moratorium of 180 days is included to permit existing contracts to lapse. No tooling-up problems are anticipated, which has been stated by two manufacturers in letters included within this analysis.

Another important advantage is that any long term decline of total new drum production caused by increased reconditioning is offset by increased initial revenues to the manufacturer from the continued purchase of new drums. Reconditioned drums are a scarce commodity at present so that no sudden change could occur. Finally, some buyers because of quality controls on their products will continue to purchase new drums in any event; this guarantees a brake on any decline in new drum sales.

H.R. 7487 is not inflationary. Many new lighter-gauge drums are purchased by chemical manufacturers whose products are among the most valuable shipped in drums. It is not uncommon for a drum's contents to sell for between $500 and $1000. If such a shipper purchases a heavier gauge drum, his cost would increase by ($2/55 gallons) 4 cents per gallon. This 4 cent increase in the price of a commodity that may sell for $10 a gallon is not inflationary.

The production of lighter gauge drums potentially affected by the tax constitutes about 14.7 million drums. One analysis by Amoco states that an initial drum price of $16.65 is representative for the most commonly used lighter drum. The collected tax of 20 percent -would equal $3.30 for a total drum price of $20 or $1.35 over the price of a heavier gauge drum. The revenue received by the government will depend on the degree to which buyers continue to purchase lighter gauge drums. For example, if all buyers continued to purchase these drums, the revenue would equal $48 million. It is reasonable to expect that only a small fraction would choose to pay the tax.

Congress should concern itself with the future of the drum reconditioning industry, because its demise would require the federal government to re-invent it, so critical are the functions carried out by the industry. Without the reconditioner, the nation would have to find disposal for 70 million drums a year and their chemical residues.

The reconditioner's problem

To recondition a fifty-five gallon steel drum rather than scrap it protects the environment, and conserves both materials and energy. Drum reconditioning as a very effective form of conservation works, but reconditioning as an industry faces market failure. Why? The industry depends on the heavier 18 gauge steel drum that will withstand many cycles of use and re-use. Its competitor is the lighter gauge drum, practically a throw-away, that can be sold at a lower cost. This advantage is more apparent than real, however, since the higher costs of the 18-gauge drum divide over the greater number of times it may be filled; the result is a substantial savings with an 18 gauge drum. Nevertheless, as the use of lighter, short-lived drums has increased, the threat to the industry has grown. Today, lighter drums dominate the market and the drum reconditioning industry faces inevitable decline.

Environmental consequences

A drum reconditioner is the ally of environmental control because he is a centralized collector of the industrial residues that typically remain in the drum after use, which may be hazardous substances. As a whole, the industry receives between fifty and one-hundred million gallons of hazardous and non-hazardous wastes a year. Without the reconditioner, the network of drum and residue disposal would collapse, and with it each of many users who sell their emptied drums to drum dealers and reconditioners would, perforce, have to find another means of disposal. Other alternatives are scarce, though, due to the low value-to-weight ratio of the drum. For still other reasons, scrap dealers do not buy drums for fear that chemical residues might contaminate scrap.

The system that does work is the disposal network that has developed around the reconditioner; yet it is sensitive to disruption. Should this disposal network fail, demand upon landfills would dramatically increase for the thousands of emptiers who would have to dispose of the 45 million drums that each year go through the reconditioning process. This flood of drums poses substantial environmental risks as a consequence of the increased demand for methods of disposal and the likelihood of increased "midnight dumping."

Resource consequences

We now seek ways to curtail the shortage of critical metals for which supply we depend on foreign sources. As a case in point, because re-use was recognized as a strategic necessity for the war effort in World War II, the War Production Board prohibited the purchase of new steel drums unless the user had used and reused his supply of drums as many times as possible. Simply put, reconditioning steel drums is conservation that works, and the common sense reasoning implicit in war-time conservation measures recognized the importance of this fact.

Drums lighter than 18 gauge represents a waste of our resources characterized by Senator Jennings Randolph in a 1972 speech, when he said, "Just imagine, if you can, a six pack of fifty-five gallon 'throw-away' cans." In quantitative terms, drum reconditioning saves one million tons of steel, enough steel to build seventeen George Washington bridges every year.

Energy consequences

Ten times more energy is needed to manufacture a new drum than to recondition a used drum. But the 18-gauge reusable drum can also be compared to the lighter, short-lived drum on the basis of the total energy needed to achieve the same number of fills. Viewed from this perspective, the 18-gauge drum requires at least 27 percent less system energy (i.e. total energy from mining to scrap) for the same number of fills.

According to the conclusions of a study by economists of the University of Illinois, "A shift from the current mix of reusable and single use drums to an all 18 guage drum system would create energy savings of 17,043 billion BTU per year. . . ." In equivalent terms, this much energy would light the Capitol building of the United States for 390 years. Although not the largest source of energy conservation, it would provide a significant contribution.

Why Congress should act now

Congress should now establish a legislative preference for the 18 guage drum through the passage of H.R. 7487, because the industry is at a critical threshold. Up to the present, the lighter, short-lived drums have increased their market share, while certain industries like the petroleum industry have stalwartly continued to use the 18 gauge drum. This situation may change within the next few years, lowering the inventory of drums below a point that will permit the industry to survive. If Congress does not act to correct this market failure, it will soon face the necessity of re-inventing this industry, should present trends go unchecked.

The drum reconditioning industry differs from any other seeking relief from market forces due to four basic reasons.

As a matter of equity, first, the reconditioner is serving a public purpose without compensation; the marketplace has forced the reconditioner to bear the social costs incurred by the manufacturer and user of lighter drums.

Second, the reconditioner effectively provides a critical function in the disposal of hazardous and nonhazardous wastes at a time when the country seeks safe methods of waste disposal. There are few, if any, acceptable alternatives. Reconditioners have invested millions of dollars in technology to remove wastes and recondition drums. Replacement of this industry or any regulatory alternative to it would entail a large federal investment.

In consequence, and as a third reason, alternatives to the reconditioning industry would unreasonably place the burden on the taxpayer when the burden should fall on the manufacturer and user of lighter drums. The remedy—H.R. 7487—is simple and effective. Removing the apparent economic incentive to use throw-away drums will correct the market failure.

Finally, this industry is the ally of environmental control, materials recycling, and energy conservation. Shouldn't Congress encourage conservation that works?

ECONOMIC ANALYSIS

The following charts and graphs document the advantage that the steel drum manufacturer has achieved over the steel drum reconditioner. In both the number of business establishments and in value of sales, the steel drum manufacturers have enjoyed significant growth. By contrast, the reconditioners' number of establishments have declined, and sales have not grown at near the same rate.

The increasing leverage of the manufacturer over the reconditioner is attributable to the capturing of the marketplace by the lighter gauge drum. If the reconditioning industry is compared to similar activities grouped in the next larger census sub-group, the difference in performance is striking, a difference attributable to the lighter gauge drum. Two decades ago, the lighter gauge drum had 15 percent of the market; today, it has 55 percent.

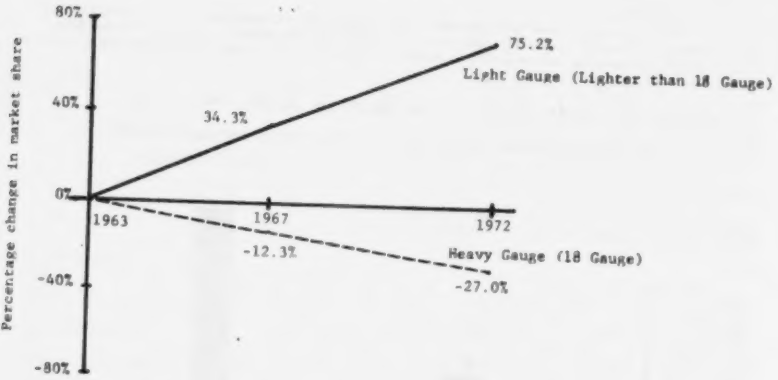
The national inventory of heavy gauge, reconditionable drums is declining. Even though the accompanying analysis demonstrates the economies possible with the use of reconditioned drums, these economies depend upon the availability of reconditioned drums.

Employment in the two industries is similar. The last Census of Manufacturers reported an employment of 12.5 thousand workers in steel drum manufacturing. About 10 thousand are engaged in reconditioning.

The purpose of H.R. 7487 is to restore a balance in these industries, because of the importance of the public benefits provided by the reconditioner. The manufacturer cannot consider himself an economic island apart from the social costs that his products cause and apart from his relationship with other parts of the economy.

PERCENTAGE CHANGE IN THE MARKET SHARE OF

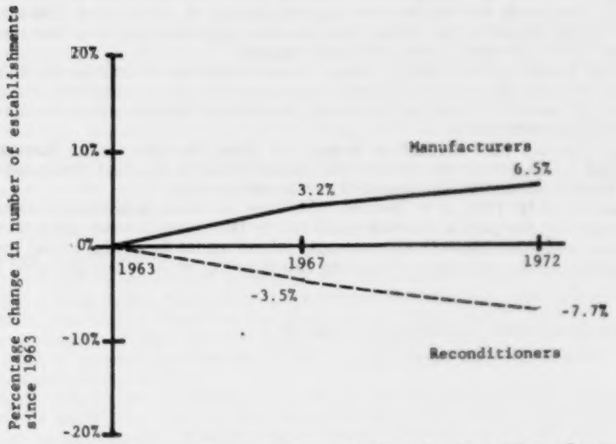
HEAVY AND LIGHT GAUGE DRUMS



This graph depicts how rapid the change has been toward the use of lighter gauge drums. This shift has reduced the national inventory of heavy gauge, reconditionable drums to the point that the benefits of reconditioning cannot be sustained. Source: The Bureau of the Census.

PERCENTAGE CHANGE IN THE NUMBER OF BUSINESS ESTABLISHMENTS SINCE 1963:

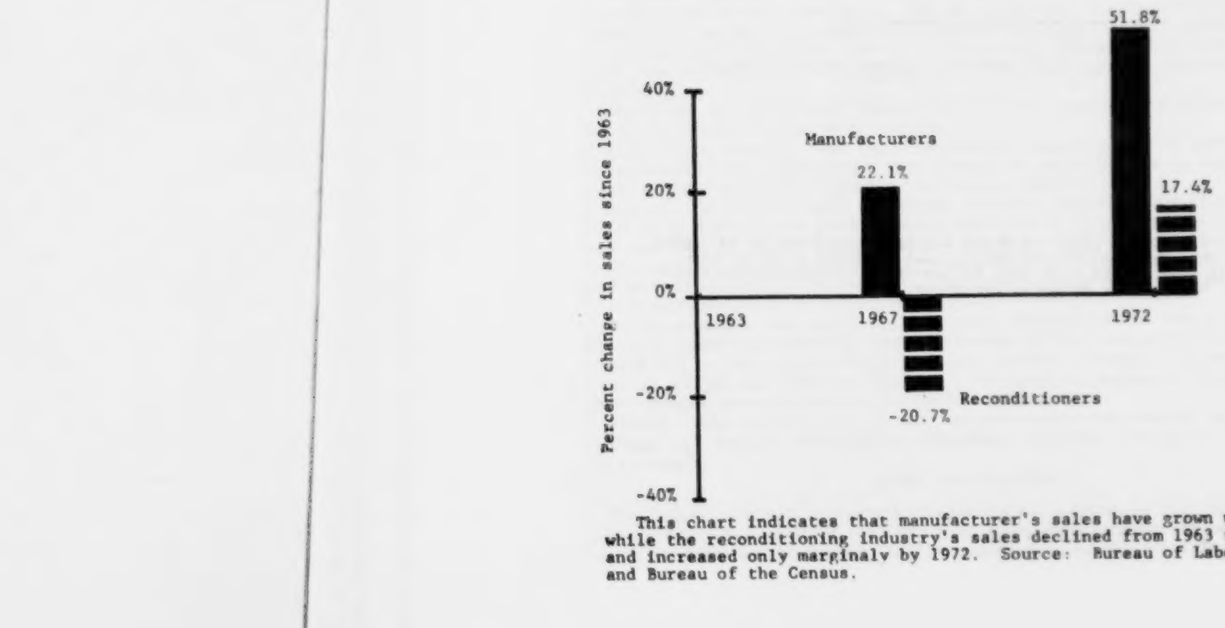
STEEL DRUM MANUFACTURERS COMPARED TO STEEL DRUM RECONDITIONERS



This graph shows the dramatic decline in the number of reconditioners doing business, and by contrast, the uniform growth in manufacturing establishments since 1963. Source: Bureau of Labor Statistics and Bureau of the Census.

PERCENTAGE CHANGE IN THE DOLLAR VALUE OF SALES SINCE 1963:

STEEL DRUM MANUFACTURERS COMPARED TO STEEL DRUM RECONDITIONERS



This chart indicates that manufacturer's sales have grown uniformly while the reconditioning industry's sales declined from 1963 to 1967, and increased only marginaly by 1972. Source: Bureau of Labor Statistics and Bureau of the Census.

ANALYSIS OF PER-TRIP DRUM COSTS

The National Barrel and Drum Association has received from Mr. James S. Brown of Amoco Oil Company, his analysis of comparative per-trip drum costs, shown on the table below. Mr. Brown assumes that a company is shipping one million drums a year and wishes to attain the lowest possible per-trip drum cost.

In the letter accompanying the analysis, Mr. Brown stated that the costs set forth below were based on actual experience. As calculated, drum reconditioning costs are included, but return freight—a variable—has been excluded. It should be noted that the economics of drum costs are sensitive to the number of trips made, which varies by company, according to the experience of Amoco; in addition, reconditioning costs may vary.

The analysis clearly demonstrates the economies possible from the use of heavy gauge drums.

	Approximate list	Number bought (thousands)	Initial cost (thousands)	Times reconditioned	Total trips	Reconditioned cost	Cost per trip
55-gal drum:							
20	$16.00	1,000	$16,000	0	1	$0	$16.00
20/18	16.65	500	8,320	1	2	5	10.83
18	18.65	200	3,730	5	6	25	7.28
18/16	19.15	143	2,738	7	8	35	6.77

COMPARATIVE PRICES FOR NEW AND RECONDITIONED DRUMS, 1980

Region	18-gauge new, tight head	20/18-gauge new, tight head	20-gauge new, tight head	Reconditioned	
				18 gauge	20/18 gauge
East	$17.00	$15.50	$14.80	$11.50	$11.50
Midwest	17.50	15.50	14.50	11.00	11.00
West	20.40	18.45	17.55	14.25	13.50
Southeast	21.05	18.95	18.25	13.00	12.00

PERCENTAGE CHANGE IN THE MARKET SHARE OF LIGHT-GAUGE DRUMS

Year	Number sold (millions)	Percent share	Percentage change (since 1963)
Lighter than 18-gauge:[1]			
1963	3.7	26	
1967	5.5	35	34.3
1972	9.4	46	75.2
1977	11.6	53	105.35
18-gauge and heavier:[1]			
1963	10.3	74	
1967	10.0	65	−12.3
1972	10.8	54	−27.0
1977	10.0	47	−36.5

[1] 55-gal steel drums; figures refer to tight head production.

Source: Census of Manufacturers.

PERCENTAGE CHANGE IN THE NUMBER OF BUSINESS ESTABLISHMENTS SINCE 1963: STEEL DRUM MANUFACTURERS COMPARED TO STEEL DRUM RECONDITIONERS

Year	Number	Percentage change
Manufacturing establishments:[1]		
1963	93	
1967	96	3.2
1972	99	6.5
Reconditioning establishments:		
1963	285	
1967	275	−3.5
1972	263	−7.7

[1] With over 20 employees.

Source: 1977 Census of Manufacturers, 1972 Census of Wholesale Trade, 1963 and 1967 Census of Business.

PERCENTAGE CHANGE IN THE DOLLAR VALUE OF SALES SINCE 1963: STEEL DRUM MANUFACTURERS COMPARED TO STEEL DRUM RECONDITIONERS

Year	Value of sales (millions)	Percentage change
Manufacturers:		
1963	$303	
1967	370	22.1
1972	460	51.8
1977	932	207.9
Reconditioners:		
1963	92	
1967	73	−20.7
1972	108	17.4
1977	NA	NA

Note: The poor sales performance of the reconditioning industry is attributable to the growth in lighter gauge drums; by way of contrast, sales of businesses in the next larger census subgrouping experienced a sales growth of 500 percent between 1967 and 1972.

Source: Unpublished data of the Bureau of Labor Statistics; 1972 Census of Manufacturers, 1972 Census of Wholesale Trade; 1967 and 1963 Census of Business.

REVENUE ANALYSIS

In 1977, production of lighter gauge drums potentially affected by the tax constituted 14.7 million drums. Taking an initial drum price of $16.65 as representative for the most commonly used lighter drum, the collected tax would equal $3.35. The total price of the drum would then equal $20 or $1.35 over the price of the 18 gauge drum.

Impact on the manufacturer

Because of present conditions of scarcity, buyers will continue their purchase of new drums—the difference being the incentive to purchase heavier new drums. Initially, then, the manufacturer is better off as a result of the tax. Presuming that present buyers of lighter drums switched to 18 gauge, the manufacturers' revenues would increase by the difference between the price of the heavier and lighter gauge drums, or $2. This difference represents a revenue increase of $30 million to the manufacturer. Such increased profits act to offset any future decline in sales from purchasers using reconditioned instead of new drums.

A reasonable estimate is that 60 percent of the new lighter gauge drums market will continue to use new drums because of quality control or other requirements. This means that the ultimate loss to the manufacturer is limited. In other words, an equitable balance must exist between the reconditioner and the manufacturer. Assuming a continuation of new drum purchases by 60 percent of the market, the maximum decline would occur if the other 40 percent used reconditioned drums. This would represent a maximum revenue difference to the drum manufacturer of a $70 million loss, against which he could apply his banked initial profits.

H.R. 7487 would cause no significant adverse employment decline in the manufacturing industry, whereas it would cause a positive affect on the reconditioning industry. To put these employment impacts in perspective, the manufacturers' total number of employees has grown by only 17 percent since 1963 while the manufacturers' sales have increased by 210 percent. In fact, in four of the years since 1963 production employment went down when value added by manufacture went up.

Impact on the buyer

Most new lighter-gauge drums are purchased by the chemicals industry whose products are among the most valuable shipped in drums. It is not uncommon for a drum's contents to sell for between $500 and $1000. If such a shipper purchases a heavier gauge drum, his costs would increase by 4 cents per gallon ($2/55 gallons). Freight charges would not cause this figure to vary significantly. This 4 cent increase in the price of a commodity that may sell for $10 a gallon is not inflationary.

Revenues to the Government

Initially, the Government will collect revenue that will decline as purchasers choose 18 gauge drums. If all purchasers continued to buy lighter gauge drums, the tax revenues would be $47 million, which represents a maximum boundary condition and not a realistic estimate. It can be expected that some fraction will purchase the taxed drums.

REVENUE ANALYSIS

Drum size	Number sold in 1977 (thousands)	Average cost	Tax per drum on light gauge	Total drum cost
18-gauge and heavier	12,790	$18.65	0	$18.65
Lighter gauge	14,720	16.65	$3.30	20.00

Note: The revenue received by the Government will depend on the degree to which buyers continue to purchase lighter gauge drums. The buyer has 2 choices: (i) purchase an 18-gauge (heavier) drum at a cost $2 higher than the present purchase price of a lighter gauge drum, or (ii) continue to buy a lighter gauge drum at a cost $3.30 higher than present lighter gauge drum prices. In the short run, some buyers may continue to purchase lighter gauge drums and pay the tax. In the long run, almost all buyers should shift to the heavier gauge drum and choose not to pay the tax.

Mr. Rostenkowski. Mr. Pearlman.

STATEMENT OF ELLIOT PEARLMAN, TREASURER, THE ACME BARREL CO.

Mr. Pearlman. My name is Elliot Pearlman. I am treasurer of the Acme Barrel Co. of Chicago, Ill. My company engages in both the reconditioning of used drums and the manufacturing of new drums. We have possibly the largest reconditioning drum installation in the country.

I am appearing here today on behalf of my company and on behalf of seven other manufacturer-reconditioners to urge the passage of H.R. 7487.

This legislation causes no significant adverse impact on the manufacturer of new drums. First, the bill contains a 180-day grace period before the excise tax will take effect. This period provides ample time to minimize any short-term market disruption that might occur. For example, existing contracts for the purchase of new drums would lapse during this time. Second, we anticipate no production-related problems, since manufacturers may easily switch from lighter gage to heavier gage drum production. In fact, the reduction in the need to produce multiple drum gages may permit some economies to occur as a result of the passage of H.R. 7487. Third, we do not anticipate any significant employment decline that would be caused by the shift to a heavier gage drum system.

This bill would impose a manufacturers excise tax on the sale of drums lighter than 18 gage. Let me describe the types of drums used in the industry. A heavier weight drum is termed "18 gage." This drum, according to our industry's tests, can be reconditioned eight or more times against the lighter 20 gage or 22 gage and so forth and so on. When we lighten the gage of a drum we drastically reduce its reusability until at some point that drum cannot be reconditioned at all and that is precisely what is happening today with the drum. This is a planned obsolescence by drum manufacturers that is dramatically reducing the supply of heavy gage used drums which successfully recycled back in the industry. It is expanding at the expense of reusable drums and with this it may become a thing of the past.

Why should we want to protect this industry? Well, consider this. In the course of conducting heretofore profitable businesses we not only provide industry with cost savings and our country with energy and raw material conservation but our industry which was referred to earlier as a horse-and-buggy industry recycles over 50 million empty drums per year. That is 50 million drums, many of which have been used to transport hazardous materials and many of which still contain hazardous residues. One gallon, two gallons, three gallons, whatever.

Now there does not appear to be any viable alternative to this collection system. Without a reconditioning industry, where will these drums go? Today you can read about isolated instances where from time to time we read about people being maimed or killed while attempting to remove the top of a drum with a cutting torch not knowing that it still contains residues of highly flammable material or that drums that were used to transport poison are being used for the storage of drinking water or for refuse containers. Can we afford to release millions more of these into the hands of an unaware public?

This is a product that can be collected and reused over and over and in this way we can continue to be the only effective vehicle for the collection of these potentially hazardous containers.

Thank you.

[The prepared statement follows:]

STATEMENT OF ELLIOT PEARLMAN, TREASURER, ACME BARREL CO. OF CHICAGO, ILL.

My name is Elliot Pearlman. I am Treasurer of the Acme Barrel Company of Chicago, Illinois. My company engages in both the reconditioning of used drums and the manufacturing of new drums. I am appearing here today on behalf of my company and on behalf of 7 other manufacturer-reconditioners, to urge the passage of H.R. 7487.

This legislation causes no significant adverse impact on the manufacturer of new drums. First, the bill contains a 180 day grace period before the excise tax will take effect. This period provides ample time to minimize any short-term market disruption that might occur. For example, existing contracts for the purchase of new drums would lapse during this time. Second, we anticipate no production-related problems, since manufacturers may easily switch from lighter gauge to heavier gauge drum production. In fact, the reduction in the need to produce multiple drum gauges may permit some economies to occur as a result of the passage of H.R. 7487. Third, we do not anticipate any significant employment decline that would be caused by the shift to a heavier gauge drum system.

This bill would impose a manufacturers excise tax on the sale of drums lighter than 18 gauge. Let me describe the types of drums used in the industry. A heavier weight drum is termed "18 gauge." This drum, according to our industry's tests, can be reconditioned 8 or more times. Its slightly higher initial cost can be divided over the greater number of trips it can make so that significant economies result. On a returnable drum system, it is a fact that the use of 18 gauge drums reduces per trip costs significantly. Traditionally, the 18 gauge drum was the standard of the industry. For example, in World War II, the War Production Board required the use of these drums for strategic reasons in order to conserve materials. Subsequently, manufacturers introduced lighter and lighter gauge dums that have become so prevalent that they have replaced the use of the 18 gauge drum.

The next lighter drum is termed a "20/18." This means that the drum possesses top and bottom of heavier gauge steel but sides of lighter gauge steel. Our careful tests have indicated that the 20/18 gauge drum can be reconditioned only three-times in typical commercial use. One company, however, carried out another series of tests that indicated the possibility of a higher number of reconditionings from this drum. During this test, the drums were carefully handled and contained only water. Under normal conditions, this drum has been determined to have a life of three reconditionings. It simply will not stand-up to the stresses of use and reuse to any greater degree.

The critical problem that is addressed by H.R. 7487 is the progressive shift to lighter gauge drums. The 20/18 gauge drum is only an intermediate step. At present, companies are rapidly shifting to even lighter drums. An all 20 gauge drum much lighter even than a 20/18 gauge drum, is growing in production and acceptance.

The move to lighter gauge drums has not stopped with the 20 gauge drum. 22 gauge drums are also being produced. Product changes are encouraging the shipment of substances in single-use containers.

My family has reconditioned drums for 3 generations. The shift in the market-place to the use of lighter gauge drums, which are in many instances throwaways, in jeopardizing the reconditioning industry. Because used heavier drums are in such short supply, many companies are shifting to the use of lighter gauge drums, and the returnable drum system is breaking down. I believe, as do other manufacturers, that Congress should encourage the energy and materials conservation offered by the use and reuse of 18 gauge drums.

This bill restores a needed balance, an equitable balance, between the manufacturer and the reconditioner. Some buyers prefer new drums for a number of reasons. H.R. 7487 simply proposes to have these buyers purchase new heavier gauge drums instead of new lighter weight drums. Clearly, the reconditioning industry depends upon the continued purchase of new drums. However, the buyers' choice should not jeopardize the entire system of reconditioning and the benefits that such a system offers to the public.

In some cases, drums are purchased for shipment overseas. I would simply note that drum reconditioning is not a national, but an international industry. We should not further the movement toward lighter weight drums in other countries by permitting any exception to the manufacturers excise tax. Furthermore, any such exception would create a situation of inequitable competitive advantage that would result in economic and administrative confusion to frustrate the purpose of this measure.

Speaking on behalf of the 8 manufacturers-reconditioners that have endorsed H.R. 7487, I believe that significant energy and materials conservation benefits will result from the passage of this bill. In addition, the bill maintains the hazardous waste management system for which the reconditioner is the hub. Reconditioners collect and safely dispose of drums containing hazardous and nonhazardous materials from both small businesses and large businesses. The returnable drum system is a system that works. The economies that can be achieved through the use of 18 gauge drums should be encouraged. We urge the passage of H.R. 7487.

Mr. Rostenkowski. Mr. Schultz.

STATEMENT OF ARTHUR J. SCHULTZ, JR., PRESIDENT, STEEL SHIPPING CONTAINER INSTITUTE

Mr. Schultz. Mr. Chairman, members of the subcommittee, I am Arthur J. Schultz, Jr., president of the Steel Shipping Container Institute.

I appreciate the opportunity to explain why our industry strongly opposes H.R. 7487 which would place an excise tax of 20 percent on steel shipping containers lighter than 18 gage.

First of all, let me state this industry's strong support of the safe transport of hazardous materials and the related aspects of the disposal of hazardous waste. As the national trade association of steel drum manufacturers, representing some 90 percent of total U.S. production, SSCI has for years been actively working with DOT in Washington in the development of effective rules and regulations to increase safety and reduce risks to the public.

Our industry provides a wide variety of steel drums and is an essential supplier of shipping containers for the national and international distribution system on which our Nation's commerce depends. A wide variety of basic products are transported in these drums including foodstuffs, chemicals, petroleum products, paints and solvents, agricultural supplies and many others which require low cost, safe and efficient transportation.

There are several areas in which the imposition of the proposed tax would adversely affect not only the steel container industry, but its shipper—customers and, as well, the consumer.

First, when you consider the wide variety of products transported in steel drums and the many modes of transportation and distances covered, domestic and international, it is clear that industry must be allowed to produce the range of containers required to meet the varying needs of our different kinds of customers. It is therefore essential to efficient transportation that technological advances be incorporated by industry into its production of containers.

The tax bill now before you would severely penalize this process, including development and production of improved containers in all but the heaviest gage steel drums of 36–65 gallon capacity by taxing the majority of steel drums of this size. It would be, in effect, a tax on innovation and the industry's ability to respond to expressed customer needs.

Such a tax would also force some shippers to abandon the use of drums in favor of plastic or fiber drums or bulk shipment methods, although under free market circumstances steel drums and clearly the least costly and most efficient method of transportation and distribution for their products.

For these and other compelling reasons, we urge this committee to refrain from imposing on the Nation's shippers less efficient, less desirable forms of packagings through the tax system.

Then there is the question of unnecessary cost increases. The total additional tax burden to shippers would amount to millions of dollars. Ultimately those who buy the thousands of consumer products now transported in lighter gage steel containers will pay higher prices as these taxes and higher shipping costs will pass through the economy, adding to our already soaring inflation rate.

From another viewpoint, it has been asserted that a tax on lighter gage drums would benefit the drum reconditioning industry. But the evidence does not support this claim. Lighter gage drums as well as heavier gage drums can be and are being reconditioned for reuse as shipping containers. Of particular importance is the fact that all drums, once they have reached the end of their usefulness, including reconditioning and reuse, can and are being recycled as scrap metal. It would be a serious waste of resources if shippers were forced by the proposed tax to abandon the use of steel drums which can be recycled in favor of plastic, paper, or fiber containers which have little or no potential for recycling. In a time of great concern over energy efficiency, it is also vital to note that use of lighter gage steel drums is more energy-efficient than use of heavy gage drums. Supporting details on this issue will be given later in this statement.

That even the "very light gage" drums can be reconditioned commercially is attested to as follows:

The Myers Drum Co., one of the largest reconditioners, if not the largest in the country, has field tested under actual transportation conditions the all/20 gage drums referred to in the Congressional Record of June 4 as the "very light gage." In the carefully monitored and documented Myers' test program, the all/20 gage drums were shipped on seven different trips and were reconditioned after each trip for a total of six successful reconditionings per drum for 89 percent of the drums tested. Therefore the fear of inability to recondition commercially is unfounded. We will be pleased to provide this committee with the specific details of this test.

It is important to recognize that this issue is far more complex than outlined in the statement that appeared in the Congressional Record. The following reasons make this clear:

(a) Obviously when discussing the proper materials to be used in the manufacture of packagings, in this case steel drums, one has to consider the requirements of all parties concerned, that is, carriers, drum manufacturers, shippers, consumers of products shipped in steel drums as well as the drum reconditioners. The carriers' packaging rules should not unreasonably burden commerce and, as indicated earlier, they should avoid subjecting shippers to economic waste by requiring them to purchase more packaging then is required for safe transport. The manufacturers of steel drums must also be able to meet customers' requirements at the lowest possible cost. Many liquids moving in commerce cannot be shipped in reconditioned drums for a number of compelling reasons. For example, quality control requirements may preclude the risk of possible contamination from a reconditioned drum, or a new drum may be needed because the product requires a special coating to prevent contact with the metal. Shippers of such commodities must have available to them suitable quality containers furnished by the manufacturers at the lowest possible cost.

(b) Drums lighter than all/20 gage steel are regularly used for certain dry form or lightweight powders or cold-setting liquids. Other products such as chemicals, food, and pharmaceuticals, for example, require the cleanliness and more rigidly certified integrity of a new drum, but do not require the heavier types for their safe transportation.

(c) It should also be noted that in some industry the performance of a reconditioned drum is considered satisfactory while in others it is not. For example, the paint and petroleum industries transport relatively low-hazard commodities, and use many reconditioned drums. On the other hand, shipments of certain very valuable and/or hazardous materials require new drums.

We believe that 18-gage drums should continue to be available to users; however, users who require new drums should not be required to purchase more packaging than they need.

At this point, we will comment on the statistics and figures used in the Congressional Record to support this tax proposal.

To our knowledge, there are no published figures on the number of reconditioned steel drums filled each year. However, as a reliable guide, we do have the U.S. Bureau of Census Current Industrial Report M34K, titled "Steel Shipping Drums and Pails." From the table in Annex "A," it is readily ascertainable that in contrast to the claim that the number of all 18 gage or heavier new drums annually produced since 1969 has decreased, in fact, the reverse is true. The table shows production of 18-gage drums and heavier was actually higher in 1978 than in 1969 by some 600,000 units.

Therefore the claim that increased production of lighter weight drums has shrunk the supply of all/18 drums is without foundation.

Another misleading contention in the June 4 statement in the Congressional Record is that the use of all heavier gage drums "will result in substantial energy and materials conservation." However, the contrary is true and can be demonstrated as follows:

The statistics provided in the Congressional Record indicated that 45 million steel drums were reconditioned last year. In the detailed analysis of Annex "B," the weighted average on the number of times these drums can be reconditioned is approximately 5 times, using 9 times for 18 gage and 2 times for lighter gage drums. (Although the number of times the light gage drum can be reconditioned is actually much higher as demonstrated earlier.) Therefore, about 1/5 or 20 percent of the reconditionable drum inventory is lost each year; specifically, 20 percent of the 45-million inventory of reconditionable drums, or 9 million used drums are lost from the inventory and must be replaced by next year's production. It should be clear that some 9 million drums need to be supplied to the reconditioners' drum inventory each year to maintain their annual production at the 45-million level. From the M34K Report data in Annex "A," there are 11 million all/18 gage or heavier plus 13 million lighter gage reconditionable new drums produced each year for a total of 24 million. Subtract the 9 million drums from the total of 24 million needed to replenish the inventory of reconditionable drums, leaving 15 million excess reconditionable drums produced each year.

This excess of 15 million reconditionable drums leaves the system for various reasons. First of all, a great many drums are not reconditioned because they are shipped overseas both commercially and for military/government purposes. Obviously, it is not economical to return these containers to the United States.

As an example, major shipping operations such as military stockpiling, the supply of lubricants to new construction sites such as Prudhoe Bay, and Government programs for exporting insecticides and other commodities to various parts of the world, including Third World countries—all serve to remove drums from the domestic recycling stream and would clearly be wasteful if such drums were heavier than necessary for that service.

It should also be recognized that many nonhazardous powdered or granular products are shipped in thinner steel drums which are authorized by highway and railroad regulations as adequate for that service. This applies as well to various petroleum and asphalt products widely distributed by major corporations from and to many locations.

One must ask what these users would do if they had to pay more for a drum heavier than they need; would they pay the price or would they go to some competitive type of nonsteel packaging? In any event, it is unlikely that people who do not require an 18-gage steel or heavier drum will pay the price for such a drum.

Touching on the environmental claim, despite the contention that the drum reconditoners act as a natonwide "network" of centralized collecting points for both hazardous and nonhazardous materials, it is evident that the U.S. Government does not consider this system adequate. Witness, for example, the voluminous regulations recently published by EPA for cradle-to-grave handling of hazardous waste and the extensive regulations developed over the years by DOT for transportation of hazardous materials; neither of these control systems is dependent on drum reconditioners. Moreover, contrary to the reconditioners' emphasis on heavier-than-necessary drums or regulated transportation, DOT authorizes lighter weight 20/18 drums which are the single largest number of drums in commerce today, and even lighter gage drums marked NRC—nonreturnable containers—for transportation of hazardous waste to authorized disposal sites. We contend, therefore, that no government or business justification exists for using any more steel in drums than current laws and regulations—or the marketplace—requires.

With respect to the availability of alternate methods of hazardous wastes disposal, the reconditioners' collection system is not a disposal system. It in fact relies on the EPA/RCRA procedures rather than EPA relying on the reconditioners. The waste product collected by reconditioners increases in volume due to their acid and alkali waste liquids which add to the volume of the residue in the drums which they collect for cleaning. Hence the disposal problem may be magnified by the addition of extremely corrosive waste liquids.

Finally, a word about progress in drum design, and opposition to it.

Steel drums have been a vital type of industrial package since the early 1900's. From time to time new developments were introduced to advance the economical and safe transportation of many commodities, both hazardous—heavily regulated—and nonhazardous—regulated to minimize damage claims.

A recent example is the introduction of an improved performance design for drum bottoms. They were subjected to extensive field testing, and application was made to the National Motor Freight Classification Committee in 1976 for authorization to use these improved designs in light weight all/20 gage drums. As had occurred periodically since the adoption of the 20/18 drums 20 years earlier, the reconditioning industry was opposed to this development which was encouraged by users of drums. The commercial trucking industry association overcame that opposition before the Interstate Commerce Commission by demonstrating that the all/20 gage drums were reliable in transportation, were reconditionable several times, and were accepted by some reconditioners whose letters were attached to the NCB testimony.

We submit that adoption of H.R. 7487 would not only lack merit but would be positively damaging to many segments of industry and the public throughout the United States. Rather than promote energy and resource conservation, it would clearly do the opposite. Rather than reduce costs, it would clearly increase them and thereby needlessly contribute to inflationary pressures. And, perhaps most significantly it would harm the interests not only of the entire steel drum industry, both manufacturers and reconditioners, but users and shippers of steel drums as well.

We trust that the Subcommittee on Select Revenue Measures will find these presentations persuasive in opposition to H.R. 7487 which proposes an excise tax on lighter gage steel drums. It has been our privilege to provide this additional perspective for your valued consideration.

[Attachments to the statement follow:]

ANNEX "A"

ANNUAL PRODUCTION OF NEW STEEL DRUMS FROM 1979 TO 1978[1]

	55-gal tight head drums			Total production of new steel drums	
	18-gage and heavier (A)	19, 20, 20/18 (B)	Total (C)	Total, all drums[2] (D)	Percent (A/D)
1969	10,522	6,453	16,975	35,542	30
1970	9,867	6,144	16,001	33,970	29
1971	10,407	7,382	17,789	36,040	29
1972	10,851	9,352	20,103	41,067	26
1973	12,032	9,917	21,949	45,549	26
1974	12,522	13,515	26,037	48,028	28
1975	9,584	10,061	19,645	36,298	27
1976	9,226	10,337	19,459	38,678	24
1977	10,912	15,045	25,957	42,647	26
1978	11,178	13,177	24,355	42,700	26

[1] From Bureau of Census M34K Report.

[2] Thousands of units.

ANNEX "B"

ANALYSIS OF INVENTORY OF RECONDITIONED DRUMS

MIXED WEIGHTS OF RECONDITIONABLE DRUMS

1. 45 percent times 9 equals 4.0 reconditionings for heavier drums; 55 percent times 2 equals 1.1 reconditionings for lighter drums; total 5.1 composite reconditions.
2. Lose 1/5.1 of 45 million drum inventory annually equals about 9,000,000 drums lost for next year which must be made up from new production.
3. 11,000,000[1] new heavier drums are produced plus 13,000,000[1] new lighter drums are produced equals 24,000,000 reconditionable new drums are available to satisfy demand for 9,000,000 drums lost.
4. 24,000,000 less 9,000,000 equals 15,000,000 drums which are not reconditioned and are not in the 45,000,000 drum inventory for various reasons.

[The following was subsequently received:]

STEEL SHIPPING CONTAINER INSTITUTE,
Union, N.J., July 11, 1980.

Hon. DANIEL ROSTENKOWSKI,
Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: I submit the enclosed supplement to my testimony to be included in the record of the June 26, 1980 hearing of your Subcommittee on H.R. 7487. This supplemental statement amplifies our industry's strong opposition to the proposed manufacturers' excise tax on 35 to 55 gallon steel drums constructed with lighter than 18 gauge steel. This statement also addresses the inaccuracies in the analysis of this proposed legislation prepared by the National Barrel and Drum Association (NABADA).

As I indicated earlier, the Steel Shipping Container Institute (SSCI) is the national trade association of new drum manufacturers, representing about 90% of total U.S. production. This industry ensures that an adequate supply of appropriate types of drums is available for transporting both domestically and internationally a wide variety of basic products, including foods, chemicals, petroleum products, paints and solvents, and agricultural supplies. The variety in the weights of steel utilized in manufacturing drums is a result of the new steel drum industry being responsive to the varied needs of its customers.

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[1] From the Bureau of Census M34K Report.

A major concern evidenced by the Subcommittee at the June 26, 1980 hearing was whether the use of the lighter gauge steel drums have adverse environmental consequences. The use of the lighter gauge drums is environmentally safe because (1) it is the waste within the drum, and not the drum itself, that can be environmentally dangerous, and (2) the use of the lighter gauge drums will not increase the number of drums scrapped because the lighter gauge drums can be reconditioned for reuse. Thus, the use of lighter gauge drums will not have adverse environmental consequences.

Contrary to the NABADA analysis, the proposed excise tax is inflationary. It could result in an increase in steel drum costs of about 14%, and those increased costs would be passed on to the consumer of the product shipped in the steel drums.

SSCI believes that the market place should determine the characteristics of the steel drums that can be utilized consistent with packaging regulations. The proposed excise tax would force shippers to utilize heavier containers than necessary, distorting the market place at a cost to the consumers of about $40 million a year. Further, it would be a waste of energy and other resources to use heavier steel than is necessary in constructing those steel drums that are never reconditioned because they are exported, or are not reusable due to the product initially shipped in the drum.

I appreciate the opportunity to address these important issues with regard to H.R. 7487, and I will be glad to provide any other information that I can to assist your Subcommittee.

Very truly yours,

Arthur J. Schultz, Jr.,
President.

Enclosures.

SUPPLEMENTAL STATEMENT OF ARTHUR J. SCHULTZ, JR.

I. INTRODUCTION

H.R. 7487 would impose a substantial penalty, i.e., an excise tax of 20 percent, on the sale of 35 to 55 gallon steel drums constructed with lighter than 18 guage steel. As stated in my testimony before this Subcommittee on June 26, 1980, we strongly oppose the proposed tax. The tax is inflationary; it penalizes millions of consumers of products shipped in lighter gage containers; and by requiring the unnecessary use of heavier gauge drums it wastes energy and other resources. Though proponents claim the tax will protect the environment, they have offered no credible supporting evidence. In fact, the "analysis" of this proposed legislation presented by the National Barrel and Drum Association (NABADA) is filled with inaccuracies which this supplemental statement will address.

II.—LIGHTER GAGE DRUMS VITAL TO SHIPPING AND RECONDITIONING INDUSTRIES

The steel drum industry provides shipping containers for the national and international distribution system upon which our Nation's economy depends.[1] Our industry works to ensure that an adequate supply of drums is available for transporting a wide variety of basic products, including foods, chemicals, petroleum products, paints and solvents, agricultural supplies and many other materials which requie low-cost, safe and efficient transportation.

Lighter gauge containers are not "throwaways" but economic and reasonable responses of the steel drum industry to the wide variety of its customers' needs. There has been a trend over the last 80 years towards lighter gauge steel drums. This trend is not unlike the trend in the automotive industry towards lighter weight cars. Both have come about as a result of economic necessity. With the development of competitive plastic and fiber drums, the new steel drum industry has had to respond to the customer requests for a better product at a lower price. In fact, data presented by the NABADA demonstrates that the lighter gauge steel shipping containers have been responsible for the continued and growing use of steel shipping containers by shippers and consequently for maintaining jobs in both the drum reconditioning and the steel industries.[2] For example, lighter gauge drums have achieved wide acceptance for many years in the chemical industry. Moreover, petroleum companies are using increasing quantities of lighter gauge drums in recent years. Thus, the variety in the weights of steel utilized in manufacturing drums is a result of the new steel drum industry being responsive to the needs of its customers.[3]

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[1] The Steel Shipping Container Institute (SSCI) is the national trade association of teel drum manufacturers, representing some 90 percent of total U.S. production.

Rather than posing a threat to the used drum reconditioning industry, the use of lighter gauge steel drums has resulted in a fifty percent increase in the total number of reconditionable steel drums. NABADA's economic analysis of H.R. 7487 indicates that the number of 18 gauge and heavier steel drums has basically remained constant, not declined, since 1963. In addition, the number of steel drums constructed of lighter than 18 gauge steel has increased almost fourfold during that same time period.[4] Not only the reconditioning industry, but also the steel are benefited by continued and growing use of lighter gage drums to maintain jobs and healthy markets for their products and services.

III. THE USE OF LIGHTER GAUGE STEEL CONTAINERS IS ENVIRONMENTALLY SAFE

On environmental grounds, there is no factual basis for favoring the use of heavier gauge drums and penalizing the use of lighter gauge drums.[5] It is the residue left in the small percentage of used containers which have transported hazardous wastes which may be a problem if not disposed of in accordance with applicable federal and state law. NABADA's claim that the use of lighter gauge steel containers can be environmentally damaging is based on a misunderstanding of the total recycling system for used metal containers.

First, the NABADA's basic premise, that the use of the lighter steel containers would put the reconditioners and their waste disposal system out of business and that increased amounts of scrap would result from the use of lighter gauge containers that are not reconditionable, is wrong. *The lighter gauge containers are reconditionable* as carefully documented test by the Myers Drum Company[6] showed.

A number of filled 20 gauge drums were shipped from six East Coast and Midwest locations to the Myers' plant in Los Angeles. The average weight of those drums exceeded 500 pounds. The drums were received in Los Angeles, emptied, reconditioned, filled, loaded on a carrier, and shipped to the company's facility in northern California, where they were again emptied, reconditioned, filled and loaded for shipment to Los Angeles. This procedure was repeated until the drums had been shipped seven times between the two plants. The company then shipped the filled drums back to the East Coast for further evaluation. The company reported that the lighter gauge steel drums are fully reconditionable.

This test buttresses the earlier findings of the Suspension Board of the Interstate Commerce Commission in a proceeding to determine whether the 20 gauge drum was a structurally sound and reliable container which would be suited for transporting liquids in motor common carriers. The evidence before that body demonstrated that the lighter gauge containers were reconditionable.[7]

Second, ensuring that a drum can be reconditioned does not *per se* eliminate the waste disposable problem. Anyone, including reconditioners, who collects container wastes must dispose of them in accordance with state and federal waste disposal requirements.[8] It is the waste in the container, and not the container itself, that creates the disposal problem. Therefore, the reconditioners do not represent a disposal system, but rather a group of collectors of waste.[9]

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[2] An Analysis of H.R. 7487: To Impose A Manufacturers Excise Tax on the Sale of Lighter Gauge Steel Drums (NABADA Analysis) at 12.

[3] For years, the SSCI has worked actively with the Department of Transportation, the Interstate Commerce Commission and other agencies in the development of effective rules and regulations for steel shipping containers to increase safety in national and international commerce.

[4] Id. Note that this fact is contrary to NABADA's allegation that the reconditioning industry "faces inevitable decline." NABADA Analysis at 2.

[5] See, e.g., Interstate Commerce Commission, Board of Suspension Case No. 65597.

[6] At the June 26, 1980, hearing, a question was raised as to whether this study was self-serving because Myers Drum Company is a subsidiary of Kaiser Steel, who would possibly benefit from increased sales of steel used in the lighter gauge steel drum. Transcript at 185. The study is not self-serving because Kaiser does not produce any sheet steel such as that used in the manufacture of steel drums. A report of this test is attached.

[7] Interstate Commerce Commission, Board of Suspension Case No. 65597.

[8] E.g., New Jersey Solid Waste Management Act of 1970, 1970 N.J. Laws, Chapter 39; 33 U.S.C. 1342; 42 U.S.C. 6901 et seq.

Third, even when drums are no longer reusable, they can and are still recycled as metal scrap. Even the small percentage of drums which have been used to ship hazardous substances are acceptable as scrap when properly cleaned.

In summary, as full and complete understanding of the total recycling system shows the use of lighter gauge steel shipping containers is environmentally safe. Taxing the use of these drums could lead to use of unrecyclable plastic and paper containers.

IV. THE PROPOSED TAX IS INFLATIONARY AND WILL BE BORNE BY THE CUSTOMERS OF THE PRODUCTS SHIPPED IN THE TAXED CONTAINERS

Despite the statements of the NABADA to the contrary,[10] the proposed excise tax will have an inflationary impact since it will increase the cost of the steel shipping containers that will be subject to the tax by about 14 percent. Assuming the correctness of the NABADA's estimate of a cost of about $2.00 more per drum to make an 18 gauge container than a 20 gauge container, it would be cheaper to buy an 18 gauge container than to pay the proposed 20 percent excise tax. Therefore, the customer that formerly purchased a lighter gauge container would buy an 18 gauge container in its place. In 1978 there were about 20 million of the lighter gauge steel containers produced.[11] At $2.00 per container, the total value of shipments for the lighter gauge containers would increase about $40 million due to the increased cost for those containers. The increased costs of $40 million would represent an increase of about 14 percent over the total value of shipments for the lighter gauge steel containers in 1978 of about $292 million.

The consumers of the product shipped in the container would ultimately bear this proposed excise tax. The companies which purchase the containers from the steel shipping container industry would pass the increased costs along to their customers. This increase in the selling price of the products shipped in the containers would make the manufacturers of those substances less competitive overseas. Further, the use of these heavier containers would increase transportation and handling costs.

Thus, the proposed excise tax is inflationary and would be passed on by the purchasers of the taxed or heavier gauge steel shipping containers to their customers of the products shipped.

V. THE PROPOSED EXCISE TAX WOULD CAUSE SHIPPERS TO UTILIZE HEAVIER CONTAINERS THAN NECESSARY

The NABADA erroneously asserts that "conservation" requires that heavier gauge containers be utilized so that they may be reconditioned and utilized a greater number of times in order to curtail the shortage of critical metals that are imported.[12] However, since sheet steel, from which the steel drums are made, is not in short supply, this type of "conservation" is not economically efficient. Since 1963, the number of 18 gauge drums in circulation has remained essentially constant.[13] It has been the reconditionable, lighter gauge container which has been the most prevalent in the recent years in the market place, demonstrating that the users of these containers have made the economic judgment that the use of the lighter gauge container is the more economic use of steel shipping containers. SSCI believes that the market place should be permitted to determine which steel drums are the most practical and cost efficient for shippers' particular uses. The proposed tax would distort the market place at a cost to the consumer of about $40 million in increased container costs, as demonstrated above.

The Internal Revenue Service (IRS) indicated in its testimony before the Subcommittee on June 26, 1980, that it opposed this proposed excise tax on the ground that it is not the economically efficient way to address the waste disposal problem. This position is confirmed by a general IRS study done concerning the recycling of solid waste materials.[14] In that study, the IRS found that the use of tax or subsidy to encourage recycling of used materials distorts the market place, thus causing a greater cost to the consumers of those products.

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[9] It should be noted that the reconditioners, in addition to being collectors, also neces- arily add some amount of waste in the process of cleaning and reconditioning of the steel ntainers.

[10] NABADA Analysis at 2.

[11] U.S. Department of Commerce, Bureau of the Census, Report M34K(78)-13 (Febru- y 1980).

[12] NABADA Analysis at 3.

[13] NABADA Analysis at 12.

Further, the tax would distort the market place, resulting in an uneconomic decision by manufacturers and utilizers of steel shipping containers to use heavier steel containers than is necessary for the job.

VI. REQUIRING THE USE OF 18 GAUGE CONTAINERS WASTES ENERGY

The NABADA claims that since it takes more energy to build a new container than to recondition an older one, it must follow that the use of lighter gauge containers, which the NABADA does not consider to be reconditionable, would result in a waste of energy.[15] Such an argument is based upon the erroneous assumption that the lighter gauge containers cannot be reconditioned. That assumption is false. But equally important, NABADA's claim ignores the total system of steel container use and that system's energy balance. For example, some 15 million drums, both light and heavy gauge, leave the system for various reasons and cannot be reconditioned. A great many drums are exported for both commercial and military or government purposes. Others are used to ship commodities, such as tar, that make the drum unreconditionable. It is a waste of steel and energy to produce steel, and fuel to transport the heavier gage drums to impose government requirements that heavier drums be used. Thus, requiring the use of 18 gauge containers for those uses would in fact waste energy and other economic resources.

VII. CONCLUSION

For the reasons stated in my testimony and those stated above, we strongly oppose the manufacturers' excise tax proposed in H.R. 7487. If I may be of any further assistance to you on this matter, please let me know.

Appendix A

REPORT BY JOHN CUTT, MYERS DRUM CO. AT THE ANNUAL MEETING, APRIL 18, 1977

REPORT ON ALL/20 GAUGE DRUM

During the General Meeting at Los Angeles in January 1977, it was decided that Steel Shipping Container Institute had to refute NABADA's charges with respect to the reconditionability of the all/20 gauge drum, if possible. If not possible and the NABADA charges were correct, then it was necessary that S.S.C.I. recognize that fact in order to resolve their allegations once and for all.

It was agreed that those companies who were then manufacturing the all/20 gauge drum would ship samples of their all/20 gauge drum to the Myers reconditioning facility in Los Angeles.

All participants (initially five and later increased to seven) were requested to ship their drums filled with water via truck; carefully documenting the distance shipped and the weight of each drum. None of the drums in the test program were shipped less than 2,100 miles, with some traveling as far as 2,500 miles. The carriers were not aware of the program, and as a result, the drums were subjected to normal carrier handling without any special instructions issued as to their handling.

The drums were unloaded at Los Angeles, inspected for physical damage and emptied of their contents at this point. A full written report was prepared on each company's shipment for the record and for their information. The drums were then sequestered until all shipments had been received.

The program established was to test the drums under actual field conditions to prove or disprove NABADA's allegations. All drums were to be tested as follows:

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[14] U.S. Department of Treasury, Office of Tax Analysis, Federal Tax Policy and Recycling of Solid Waste Materials 45 (February 1979).

[15] NABADA Analysis at 4. The NABADA study that is the basis of its conclusion incorporates a number of assumptions that are not well documented. For example, the study does not document its source for the number of times an 18 gauge drum and a lighter drum can be reconditioned, other than "[i]nformation on the energy used to recondition drums was supplied by a reconditioner who prefers to remain anonymous." Prussing and Prussing, The Energy Requirements of Steel Drum Manufacturing and Reconditioning 7 (Feb. 14, 1974).

1. Shipped to Myers as previously described.
2. Unloaded, emptied, inspected and reconditioned.
3. After the initial reconditioning trip, the drums were filled once again with water and shipped via Myers truck to its Northern California plant; where they were unloaded and then reloaded for a return truck trip to Los Angeles, a total round trip distance of 850 miles.
4. Upon receipt at Los Angeles, the drums were unloaded, inspected with a full written report and reconditioned once more.
5. This process was repeated a total of six times with accurate records maintained of the condition and recondionability of the drums in this program.

Except for some minor reduction in the dedenter air pressure, the drums were handled in the exact same manner as our production. Let me repeat, with that one exception, the drums were processed through the normal reconditioning procedures.

A representative sample (one drum) was taken from each manufacturing shipment and the chime cut to measure the gauge of the steel used by each manufacturer. This was done for the purpose of refuting any later charges that the drums tested might have been of a thicker gauge. The drums used in this program measured .033 to .035, well within the 20 gauge decimal range.

The initial reconditioning trip was purposely delayed until the S.S.C.I. General Meeting that was held in Los Angeles in January. At that time, a number of the submitting company representatives were on hand to view this trip through the reconditioning facility. After the first trip, all of the drums were chained to see if the chaining operation had any impact upon the drums. May I report to you, at this time, that all drums were successfully chained without any adverse effect.

The initial test pack from each participating company was for six drums with one drum used for gauge verification. The remaining five drums were loaded and unloaded on trucks a total of fourteen (14) times each, including the first shipment from the manufacturing plant. The drums had traveled an average distance of just over 7,000 miles and had been reconditioned six times each, except where failures did occur.

The twenty five (25) drums used in this testing program were successfully reconditioned a total of 133 times out of a possible 150 scheduled, for a success factor of 89%. No failures occurred prior to the *third* trip, with one failure occurring at the end of the sixth trip; two at the end of the fifth trip and two at the end of the fourth trip. Bear in mind that the failures, while not usable for tight-head use, could be converted to non-regulated full open top (FOT) usage. In other words, the rejected all/20 gauge drums were not scrapped but could be converted to other uses.

One last point, we believe that the parameters established for this test accurately represent the best field simulated conditions yet devised for a testing program of this nature. The point proved is that the all/20 gauge drum is reconditionable and refutes completely NABADA's charges. These results have been carefully recorded and documented and each company's results, with supporting pictures, have been distributed. Continued testing will take place. Two other manufacturers have requested that we test their drums under similar conditions; which we will do.

Bear in mind that most of the drums are still in good, usable condition and in ll likelihood could be reconditioned two, three or even four additional times.

Mr. Rostenkowski. Thank you, Mr. Schultz.

Who bears the cost of these wastes, and if there is a cost, is that assed on to the consumer?

Mr. Hershson. At this time and up to this time the reconditioners ore the costs of disposal of the waste which they received and conolidated and sent to either treatment facilities or secure landfills, but ecause of the tremendous volume of input that is coming in, we are a position where we need help in that regard. We are not looking r help from the Government but we want to get the empty drums, ose who give us drums with 1, 2 or 3 gallons, to give us some addional help so that we can pay for the eventual disposal of their waste. At this moment we absorb the waste cost.

Mr. Rostenkowski. In the disposal of hazardous wastes, what is the scope of the regulations in which the reconditioning industry is subject?

Mr. Hershson. You mean the record regulation as they are presently written, and will be in effect in November, drums which contain any hazardous material which are not listed on a special schedule found in 261.33(e) of the Resource Conservation and Recovery Act's regulations. In the RCRA regulation, if they are not listed on that schedule, such drums are exempt from the regulations, so that when we become generators, there is no manifest system or transporting system or any other system required between our emptiers and ourselves; we become the collection system for the residues. When we send it out we are generators under RCRA.

Mr. Rostenkowski. Well, Mr. Hershson, are not chemical manufacturers likely to continue using new drums for quality control purposes?

Mr. Hershson. I think both Mr. Schultz and others have mistaken the impact of this. We are not saying you must buy a reconditioned drum; you are perfectly at liberty to buy a new one. We are suggesting to this committee that the chemicals industry which buys lighter than 18-gage drums new, should buy 18-gage drums so that they too can be involved in society's cost in not having a good system of reconditionable drums available in this country.

We are not asking to be shipped by anyone from new to reconditioned drums.

Mr. Rostenkowski. How labor-intensive is your industry, Mr. Hershson?

Mr. Hershson. Our industry is about as labor-intensive as the new drum industry, and perhaps a little more. I can't give you a percentage figure, but perhaps Mr. Pearlman can.

Mr. Pearlman. I would say on an individual plant basis we are more labor-intensive than a manufacturing facility would be.

Mr. Rostenkowski. The argument has been made that whether or not a system is based on the sale of light gage drums, the drums will still leave the system without being reconditioned.

Where are their drums going and how many would still leave?

Mr. Schultz. I want to be sure I understand your question. Are you saying if we don't have a reconditioning industry what would become of used drums?

Mr. Rostenkowski. Yes.

Mr. Schultz. Our contention is that the reconditioning industry has been in existence for 40 years and it will be in existence long after us, Mr. Congressman. I don't think we have any fear that the industry will go downhill. As I mentioned earlier, if you are looking at the report, all 18-gage drums have gained slightly, and has remained roughly between 11 and 12 million drums over the past 10 or 11 years.

The only increase in the past 10 years has been in the so-called lighter gage drums of the variety that can be reconditioned. These drums were developed to compete with plastic, fiber and bulk shipments in order to improve our industry's share of the market. There was concentration in this area. There were research programs to find a better steel drum package in order to capture some of this business, and they did. But the increase did not come from the heavy gage drum production because the heavy gage drum production has not decreased.

I might add also that Mr. John Cutt, general manager of the Meyers Drum Co., the largest reconditioner in the country, and who has been in the business for over 20 years and a very large drum manufacturer as well, has absolutely no fear that the reconditioning industry is going downhill. There are many other reconditioners that have the same feeling.

Mr. Rostenkowski. Mr. Schultz, you argued that old barrels can be reconditioned but in practice don't the heavier gage drums stand more reconditioning and make more trips?

Mr. Schultz. There is no evidence to support that, Congressman. The number of times that a drum can be reconditioned is not so much the gage of the drum as opposed to the handling of the drum in transportation.

I mentioned earlier the number of drums that are required to keep the reconditioning industry at the 45 million level. There are plenty of drums produced for that purpose. The problem is that the majority of the drums leave the system for one reason or another. We say that would be energy inefficient to require these drums to be heavier than required to meet the safety requirements of DOT.

Mr. Hershson. May I comment on these questions?

First of all, Mr. Schultz is completely and totally wrong when he says that there is no difference in the number of reconditionings possible.

Mr. Schultz. I don't think I said that.

Mr. Hershson. We have in the record of the House Committee on Transportation and Commerce letters from Amoco Oil Co., Chevron, and Continental Oil Co. that they have tested the 18-gage drum against the lighter drum and, because of the number of trips that the 18-gage drum makes they have discarded the lighter drum on their returnable drum system. That is in the record. Everyone in the drum industry knows whether new drums or reconditioned drums, that a heavier gage drum takes a greater number of trips than a lighter gage drum. To argue the contraray is just not to argue facts.

Mr. Rostenkowski. I would like for all witnesses to understand we are trying to write a record here and I think that the contribution you are making is going to be essential to just where the committee is going to move.

Now, Mr. Schultz, would you like to comment?

Mr. Schultz. I would like to mention again that I have a letter from Mr. John Cutt, in which he states.

> H.R. 7487 contends that the future existence of the reconditioning business is dependent upon availability of heavier gage steel drums which can be reconditioned. This is completely erroneous. We have, over the years, conducted numerous tests relative to the reconditionability of 18-gage steel drums versus lighter gage drums.
>
> The truth of the matter is that the gage of the drum does not really determine the reconditionability of the steel drum. What really determines the reuse fraction of the steel drum is how the drum is handled while in transit.

There is a difference of opinion on this matter and, yes, I think we lo need more facts. But from people I have talked to who have a great

amount of experience in the reconditioning business, and we hav
dozen of our own members in it, I don't get the same reading.

Mr. Guarini. Mr. Schultz, doesn't Mr. Cutt work for a subsidia
of Kaiser Steel which makes his a very self-serving statement? Is
that correct, sir?

Mr. Schultz. Pardon me?

Mr. Guarini. You put in the record a statement by Mr. Cutt whi
you have read.

Mr. Schultz. Yes, I did.

Mr. Guarini. Isn't it true that he is the head of the Meyers Dr
Co., which is a subsidiary of Kaiser Steel?

Mr. Schultz. That is correct.

Mr. Guarini. And isn't that a very self-serving statement?

In other words, you would be making fewer drums if you were m
ing lighter drums, is that correct—I am sorry. You would be mak
more drums if you were allowed to make the light drums, is t
correct?

Mr. Schultz. I wouldn't say that is correct, no, sir.

Mr. Guarini. You know the argument that you gave is very mu
like the argument that we heard on the Hill concerning large c
that the customers wanted and demanded larger cars. You said in y
statement that the customers want these lighter gage steel drums.
course the big cars got us into a great deal of difficulty and we di
fact pass an excise tax on the gas guzzlers, in order to try to corre
very bad energy situation.

It seems to me that we have somewhat the same kind of a statem
from you concerning lighter gage drums. I would like to ask you, w
is the track record of your industry in regard to OSHA? Haven't m
serious violations been found in the steel drum manufacturing in
try as compared to the reconditioning industry?

Mr. Schultz. Congressman, I don't have those figures available.
viously you do have some available. What numbers do you hav
have never had those numbers. What is the source?

Mr. Guarini. Would you not admit that the number of serious
lations is considerably larger in the drum manufacturing indu
than in the reconditioning industry?

Mr. Schultz. I don't know, sir, because I haven't seen the numb
I would suggest that if you haven't gone through a new steel d
plant and/or reconditioning plant that you visit them and make
own determination. From my visits to all of them I would say tha
OSHA violations should be no higher in a new drum plant than
reconditioning plant.

Mr. Guarini. I guess on the other hand I am wondering what b
ing this question has on the issues before the panel. We are intere
in serious, hazardous waste disposal problems.

Mr. Schultz. We all are.

Mr. Guarini. Which have been of great moment in our cou
Only last week we reported out of committee a $1.2 billion bi
order to try to eliminate that problem, but this is only just the ti
the iceberg. We are now going to put a considerable tax on indu
in order to try to allay some of those public expenses that are bein
curred. Many of them have been as a result of the discarding of
and deleterious materials in steel drums.

I have visited fields in my city where I have seen the results of numerous midnight dumping incident involving steel drums of the kind you have described.

I would like to ask you what your industry has done in order to eliminate this grave national problem. What have you done as an industry, sir, because it has been your drums that have caused in great part the situation which we have today.

Now, we don't tax you, even if you are duplicitous in the situation. We seem to be taxing the chemical manufacturing industry. But I wonder whether or not we are putting emphasis on the chemical industry which should be on your industry as well.

Would you comment on that?

Mr. **Schultz.** Well, I would say that our industry, and I mentioned this earlier in my statement we are very much interested in the proper disposal of hazardous wastes. I am concerned about that problem as much as you are. I am also from New Jersey and I have seen some of the problems you are talking about. We have stressed in many articles the fact that a steel drum is a shipping container and not a container to be used for storage. We do not condone storage of toxic materials. Once that drum is sold to a customer the manufacturer of that drum has no control over it.

Now, we stress the fact again that the drum is to be used for transportation and not for storage, but if unscrupulous people choose to do that, sir, I don't think that the new drum manufacturers should be held responsible.

Mr. **Guarini.** Would you concede that much of the hazardous waste situations we have today is a result of improper disposal in steel drums?

Mr. **Schultz.** I would not say it is or it is not because I don't know of any figures available to indicate that one way or the other. I think that is one of the problems, Congressman, that we do not have the figures available. The only thing we have available is the M34K report by the Bureau of the Census.

Mr. **Guarini.** You are not aware of the Elizabeth, N.J., situation?

Mr. **Schultz.** I am absolutely aware of it.

Mr. **Guarini.** The problems there have created a tremendous public hazard. The disposal of some of these barrels is costing the Government as much as $600 per barrel.

Mr. **Schultz.** I am aware of that very much, sir.

Mr. **Guarini.** And the life and safety of the people in these towns where these barrels are clandestinely stored is endangering the public, and yet you say that you are not fully aware of the extent of the problem or the contribution that your industry has played.

Mr. **Schultz.** I misinterpreted your question. I thought you were talking about the numbers involved. Yes, I am certainly aware of the situation in Elizabeth, and my office is in Union, N.J., and I live in New Jersey. I am very well aware of the problems there and we are concerned about these problems, not only as a manufacturer, as a trade association, but also as members of our society.

Mr. **Guarini.** You have a colleague here, Mr. Pearlman, and you heard him testify, and he is from the manufacturing side as well as you are. He is at great variance in the testimony that he gave with what you gave.

Mr. Schultz. I agree with that.

Mr. Guarini. There has to be a lack of credibility somewhere, b
cause apparently you have the picture from the same vantage poi
What do you think your industry should do to be responsible, a
where do you think the answers lie?

Do you think your industry should take some of the burden of t
responsibility that we have for hazardous toxic wastes, or do y
think that you should be just allowed to do what you want to do a
make even lighter gage drums?

Mr. Schultz. Mr. Congressman, I do not think that the producti
of lighter gage drums contributes to the problem that you are outl
ing. It makes no difference whether 12- or 14-gage or 16-gage or
gage drums are used. When a steel drum is used improperly, as th
have been used in New Jersey and Elizabeth and elsewhere, you
still going to have the same problem of the disposal of toxic wastes.

I think we have to put the emphasis on the use of the drums aft
they are manufactured. When they are stored by unscrupulous peop
like those who stored them in Elizabeth we are going to have problem

I think the laws and the enforcement of those laws ought to ta
care of that situation.

We will cooperate and will always cooperate in any way we can.

Mr. Guarini. What do you think your responsibility should b
Cooperation is easy, but what positive steps would you suggest, if y
concede that many of the deleterious chemicals like vinylchloride a
some of the dangerous materials—even nerve gas—which in Elizabe
N.J., some people were fearful might exist—what do you think t
responsibility of your industry is other than just to cooperate?

Mr. Schultz. I think the responsibility of the manufacturer, M
Congressman is to manufacture a drum which has high quality
prevent that drum from leaking.

The steel drum manufacturers put out a good product and th
have to tell the users of the drum that it is a shipping container and r
a storage container.

Now, beyond that, if you have some recommendations, we wou
like to hear them, because we do want to cooperate.

Mr. Guarini. A recommendation could be either that they be tax
or that they be outlawed completely. Now, which would you rather
happen if you had your choice between those two?

Mr. Schultz. What outlawed completely?

Mr. Guarini. The lighter steel drums.

Mr. Schultz. Well, that is where we take exception, because we s
that the lighter guage drums are not the culprit.

Mr. Guarini. Mr. Pearlman, would you respond to that, sir?

Mr. Pearlman. I would like to respond to one thing that was sa
earlier, and Mr. Schultz was asked point blank, what would happ
to all of these used drums if there were no reconditioning busines

I would like to note that the response was, the reconditioning bu
ness has been around for 60 years and they are going to stay aroun

I didn't hear any practical solution to whether or not or what wou
happen if the reconditioning business did go out.

Now, I think one of the cruxes of the matter is, will the reconditio
ing business stay around or not?

I would like to add just one viewpoint to that: Over the past couple of years, because we are desperately attempting—reconditioners are attempting to fill the gaps in our distribution and in our marketing systems, quite a number of us have gone into the manufacture of new drums. I don't see one drum manufacturer who has done the reverse, who has gone into drum reconditioning, over the past few years.

If our business is so rosy, why isn't that taking place?

Mr. GUARINI. Who has been the greatest disposer and handler of the steel drums? Is that the reconditioner?

Mr. PEARLMAN. Absolutely the reconditioner.

Mr. GUARINI. Have they been central in a system of handling and disposing of toxic wastes that would be in these drums?

Mr. PEARLMAN. Yes, sir.

Mr. GUARINI. And is that industry the key in the disposal system of the United States for hazardous wastes?

Mr. PEARLMAN. Yes.

Mr. GUARINI. And is that industry growing or is it getting smaller in size?

Mr. PEARLMAN. That industry is certainly not growing, and certainly it is getting smaller in size. We are now at the crossroads.

I think another statement Mr. Schultz made was that the number of reconditioners has no connection with the gage of the drum. How far do we go? You mean to tell me if the gage went to 20, 22, or 26 it would still have no connection with the gage of the drum? Sooner or later the drum can't be reconditioned and we are at that crossroads.

Mr. GUARINI. Is there any question about the reconditioning industry members having met their responsibilities in the manner in which they dispose of these wastes?

Mr. PEARLMAN. There is really no question that we are handling this in the most safe and efficient manner that is known to the industry today.

Mr. GUARINI. Is there a trend that there are more and more lighter drums here and throughout the world?

Mr. PEARLMAN. Absolutely.

Mr. GUARINI. And is it because of the economics that makes this so, sir?

Mr. PEARLMAN. Frankly, I think we have shown that the economics are not there with the light-gage drum. I think it is industry being very casual and not caring, because they can pass this cost along. It actually is more trouble to use a reconditioned drum than it is a new drum. It is cheaper; it is safer and beneficial to this economy, but it is more trouble.

I think we are finding more and more of that today, as long as costs can be passed on.

Mr. GUARINI. Now there is a question about whether or not some people prefer new drums. This legislation does not take new drums away from them, does it?

Mr. PEARLMAN. Absolutely not.

Mr. GUARINI. If they wish to buy the new drums and have their special kind of lining, they still have the opportunity of having whatever kind of drums they want, whether it is reconditioned or a new drum?

Mr. PEARLMAN. Our industry is based upon the initial purchase
new drums.

Mr. GUARINI. What about the argument, Mr. Pearlman, that
should be able to export light drums overseas? Will you comm
about that? Should we export light drums overseas? What is
experience in Japan, England, and among our allies and even in
African countries in regard to the handling of light drums?

Mr. PEARLMAN. I wonder if I might defer to Mr. Hershon on t
particular question? He has information from some of our associ
members in other countries.

Mr. GUARINI. We do not want to block a good market, but should
have that market, Mr. Hershson?

Mr. HERSHSON. Of course, Mr. Guarini, we should have a market
our exported material around the world. There is no question ab
that. The crux of your question is, will an excise tax on lighter th
18-gage drums reduce that market?

In my opinion, it will not reduce that market. The market w
remain the same, I think. I could be wrong, but I believe the mar
will remain the same.

However, throughout the world there is a tendency toward regu
tion of hazardous materials in drums heavier than the light-ga
drums, many of which are being manufactured in this country. The
fore, it seems to me that we should have at least for hazardous ma
rials, at least the regulatory provisions that are in existence around
world.

Now, the light-gage drums that Mr. Schultz is talking about
not one which are being used for hazardous materials in transpor
tion, because foreign countries in many instances will not accept the

Mr. GUARINI. What about drums we send to Alaska, which can't
returned too easily, have we had a problem with that?

Mr. HERSHSON. The problem is that there is no reconditioner the
and the drums line the highways and byways of Alaska and they
rusting away.

Mr. GUARINI. Do we have a potential environmental problem
there?

Mr. HERSHSON. Because of the absence of reconditioning faciliti
yes, Mr. Guarini.

Mr. GUARINI. Would this bill cause any loss of jobs? We have
economy which is going through a recession at this time, and what c
be done?

Mr. HERSHSON. I believe in balance there will be no loss of jobs,
sir. There might be a shift of five laborers from one plant and one i
dustry to another plant in another industry, but in balance there wou
be no loss of jobs.

As a matter of fact, I think there might be an increase of jobs.

Mr. GUARINI. Mr. Schultz, do you want to comment on that?

Mr. SCHULTZ. I might add, Mr. Congressman, the Eastern St
Barrel Co., in New Jersey has been in business for some 33 years, a
they manufacture nothing but lighter gage drums, many of which a
used to transport tar and other things. They are not equipped, but
being innovative, I suppose, they could find a way to make heavi
gage drums.

I think any statement or any way to answer that question would be speculation, as was the answer that Mr. Hershson gave you. I don't know.

Mr. GUARINI. All right.

Mr. DUNCAN. I think most of the questions have been answered, and I do want to thank the panel. It has been a very good one. Thank you.

Mr. GUARINI. May I ask about the scrap dealers and the problems associated with them, when we have light drums?

Could either one of you discuss whether or not scrap dealers provide an alternative method of disposing of these lighter drums?

Mr. HERSHSON. I would be glad to answer that.

An unreconditioned or uncleaned drum is not acceptable to the scrap industry, because it is a contaminated drum and therefore contaminated scrap.

The scrap industry does not want to handle contaminated scrap. That is for several reasons. The scrap drum which contains hazardous residues in the drums is an unknown factor to the scrapman. The scrapman, when he puts that drum in a compressor to compact the drum, has experienced, in many instances explosions. He has experienced injury to person and damaged property and so he wil not accept drums which have been emptied of hazardous material and have some waste in it, and you couldn't pay him to do it. He will accept them from us because we have cleaned the drum, and we find that the drum is no longer usable for transportation purposes or it has a hole in it, for example, and so that drum is sent to the scrapyard. The scrapman will accept them from us, and reluctantly.

It is not a highgrade scrap; people are not happy with this empty steel drum and will take them in the main from no one else but the reconditioned drum industry.

Mr. GUARINI. Is that a fair statement, Mr. Schultz?

Mr. SCHULTZ. I would like to have Mr. Smith, who is vice president of Container Division of Inland Steel, answer that question.

Mr. SMITH. Congressman, could I point out that probably only 20 percent of the drums either new or reconditioned are used for hazardous materials. Eighty percent of the drums are used for materials which have no hazard whatever; in fact, many of the products are edible products that go into drums; they do not pose a hazard to the country.

Mr. GUARINI. Twenty percent could be a rather large problem if it involves a toxic chemical, even 10 or 5 percent could be, if it is the wrong kind of chemical.

I don't want to prolong this because I understand I have gone beyond the time I wanted to take. But was there a comment that you wanted to make?

Mr. PEARLMAN. That 20 percent of hazardous material is classified by the Department of Transportation. The new recla laws are expanding upon that list greatly. Maybe we do not call it hazardous but to a person certainly these additional materials are hazardous to the environment. Thank you.

Mr. GUARINI. I want to thank each of you for giving us the benefit of your thinking on this bill.

Our next witnesses are Mr. Robert Partridge, executive vice president and general manager of the National Rural Electric Cooperative

Association, accompanied by Mr. Wallace F. Tillman, regulator counsel; Mr. Michael Barry, legislative counsel, National Telephon Cooperative Association, accompanied by Robert J. Leigh, director o legal and government affairs; and Mr. Heywood C. Gay, executiv vice president of the Georgia Electric Membership Corp.

Thank you for being here and as soon as you get settled at the tabl we will hear from Mr. Partridge.

STATEMENT OF ROBERT D. PARTRIDGE, EXECUTIVE VICE PRESIDENT, AND GENERAL MANAGER, NATIONAL RURAL ELECTRI COOPERATIVE ASSOCIATION, ACCOMPANIED BY WALLACE I TILLMAN, REGULATORY COUNSEL

Mr. PARTRIDGE. Mr. Chairman and members of the committee: M name is Robert D. Partridge, executive vice president and genera manager of the National Rural Electric Cooperative Associatio (NRECA). I am accompanied here today by NRECA's regulator counsel, Wallance F. Tillman. NRECA is the member-service organization of the more than 1,000 rural electric systems providing centra station electricity to more than 25 million consumers in 2,600 of th Nation's 3,100 counties in 46 States.

My testimony today is for the purpose of expressing the full suppor of NRECA and its member systems for H.R. 7520. It is difficult t envision an issue that has broader application to our members tha the one dealt with by this bill. Certainly there is no issue before thi Congress of more immediate concern to our membership. This concer was expressed by the following resolution unanimously adopted b some 11,000 delegates to NRECA's 1980 annual meeting:

POLELINE ATTACHMENTS/RELATED BUSINESS INCOME

> To serve the public interest, to promote rural development, to avoid duplicatio of utility poles, to protect against an unsightly environment, and to bring servic to the greatest number of people at the lowest possible cost, the rural electri systems have entered into reciprocal agreements to share the cost of using an maintaining their utility poles. Joint use minimizes costs and encourages th efficient use of rights-of-way. Traditionally the Internal Revenue Service (IRS has treated revenue resulting from joint use agreements as business-related an thus non-taxable. However, recently, the IRS has shifted this long-standing polic and has begun taxing this income, claiming that the rental bears "no substantia causal relationship" to the rural electric cooperative's exempt purpose. To tak issue with the IRS, we believe the purpose of rural electrification is to provid full and adequate service to cooperative members.
>
> We, therefore, support legislation introduced by Congressman Albert Gore, Jr of Tennessee entitled The Rural Cooperative Business Income Act. This bill wil treat as related income, revenue received for activities normally provided by ar electric utility.

Subsequent to the passage of this resolution, Chairman Ullman an Representative Gore along with several other Ways and Means Committee members introduced H.R. 7520 addressing specifically the pol attachment issue. We wish to express our deep gratitude to the sponsor of this bill and for the opportunity of testifying here today. We believ this legislation should never have been necessary and that our systems legal challenges of the IRS' position would ultimately prevail in th courts. However, without legislation it would be years before the issu could be resolved and, only then, after a great deal of unnecessary cost and manpower expense.

This matter first arose in the summer of 1977 when IRS agents auditing Consumers Power, Inc., a rural electric cooperative located at Corvallis, Oreg., questioned whether pole rentals were unrelated business income. In order to obtain a determination on this issue, the agent asked for a national technical advisory opinion. The cooperative came to Washington in November 1977, for a national conference with the Service and filed its brief setting forth its arguments as to why these rentals were not unrelated income.

In March 1978, the Service determined that income received by the cooperative from the leasing of space on its utility poles is subject to the unrelated business income tax. The system was not billed by the IRS until May 1979, at which time, it paid under protest and requested a return of the moneys paid. The request was in effect denied by the expiration of 6 months time, as after this lapse such requests are considered automatically rejected. On March 5, 1980, suit was filed in the Federal District Court for the State of Oregon for return of the moneys paid under protest. Court prehearing conferences thus far have resulted in a stipulation by the Government to finish its discovery by December 26, 1980, and to expedite the case. A final court resolution time frame is uncertain, but surely it would be years from now.

In the meantime, activities such as this are occurring around the country. A favorable decision in the Federal court in Oregon would not be binding in other Federal court districts. Without legislation such as H.R. 7520, it is almost impossible to project either a final resolution of this matter or the magnitude of wasted time and money.

Since the IRS ruling in March 1978, cooperatives around the country have been the targets of audits, requirements to file 990–T's, and assessments. I know of no cooperative that has not taken the position that the IRS is wrong from both a legal and public policy standpoint.

It seems inconceivable to these systems that an activity carried on since the 1940's and examined by the IRS in numerous instances could suddenly be determined to be unrelated and subject to income tax. It is difficult for them to understand the inflexibility of an interpretation of law which is totally contrary to previous determinations.

Our members become even more suspect of the IRS' motives when the cooperatives' expense methodologies are rejected, with the Service allowing deductions of offsetting expenses for only the few inches actually used for the line attachment. We are yet to find an attachment 20 feet off the ground that needs no support from below.

As the committee is by now aware, we are in substantial disagreement with the IRS over its position. I will from this point forward be more specific. My objections are basically twofold:

1. The Service's position is not in the public interest, and
2. The Service's position is not defensible from a legal perspective.

Let me initially say that it is difficult to accept that any activity carried out by every segment of the utility industry could be unrelated to the purpose for which the utility does business. In this case it is the rental of space on utility poles for attachments of other lines, specifically telephone or cable TV. All segments of the utility industry whether investor-owned, municipally owned, or cooperatively owned rent space on their poles for utility attachments and have done so for years. It is an integral component of providing electrical service.

The legislative history of the Rural Electrification Act of 1936 and the 1949 rural telephone amendments to that act establish that their purposes are to enhance the public good by providing rural areas with areawide coverage of central station electricity and telephone service. The committee reports accompanying the telephone amendments to the Rural Electrification Act of 1949, in fact, specifically noted that telephone service and the joint use of poles would facilitate the implementation of Congress intentions as expressed in the act of 1936 and amendments of 1949. Language in Senate Report No. 1071, 81st Congress, 1st session, reads:

> In fact, the lack of good rural telephone systems is even working hardships on the extension of electrical service to rural areas because the farmer is unable to notify the local company or cooperative that the electrical service is broken down.

Additionally, it should be noted that Congress purpose in the granting of tax exemption to the nonprofit telephone and electric utilities was due to the fact that such nonprofit cooperative utility businesses serve the public good. It would appear to follow that activities which contribute importantly to serving the public good, rather than a private profit interest, are substantially related to the exempt purposes and, therefore, do not result in taxable business income. Further credibility is lent to the argument by a decision in the U.S. Court of Appeals for the Sixth Circuit in *United States* v. *Pickwick Electric Membership Corp.*, 158 F.2d 272, 35 AFIR 272 (1946). The court noted that rural electric cooperatives are exempt not only because of the provisions of 501(c)(12) but are also exempt as organizations "operated exclusively for the promotion of social welfare" as provided in section 501(c)(4), IRC.

Possibly the most important point to be made, we believe, is that an examination of the legislative history surrounding the unrelated business income tax provisions of the code leads one to conclude that this tax was not intended by Congress to apply to revenues such as pole rentals. Congressional concerns over the expansion of tax-exempt entities into a wide range of business activities led to the concept of unrelated business income. This concept resulted in the enactment of the unrelated business income tax in 1950 and 1969—when it was extended to apply to 501(c)(12) organizations. This tax was aimed at unfair competition. That is, if tax-exempt entities were expanding into unrelated areas and, therefore, unfairly competing with taxpaying organizations, such activities should be taxed. Clearly, there is no issue of competition where pole line attachments are involved. The electric utility industry is a rigorously regulated monopoly; each utility serves well-defined geographical territories. We believe the IRS recognizes this congressional intent through regulation 1.513-1(b) which states that the primary objective of the unrelated business income tax is "to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavor with which they compete."

We would also like to note that Federal, State, and local governments encourage in some instances, and mandate in others, the joint use of utility poles. There are numerous examples and references we could use to support such a statement but will note only a few.

REA requirements, as expressed in numerous bulletins, encourage mandate the joint use of poles for safety, health, economic, environmental, and public interest reasons. REA makes loans available to borrowers for the installation of poles capable of joint use and for other increased plant and equipment costs associated with joint use. Certainly REA lacks the power under the Rural Electrification Act of 1936 to loan money for or require an electric borrower to engage in any business which is not related to "the furnishing of electricity to persons in rural areas who are not receiving central station services."

Other Federal agencies, such as the Interior and Agriculture Departments, mandate joint use in crossing Federal lands. The National Electrical Safety Code requirements mandate joint use as do Federal, State, and local environmental laws.

State regulatory commissions generally require joint use reciprocal agreements of the utilities they regulate. These commissions could hardly be accused of requiring their regulated utilities to engage in activities unrelated to their purpose.

Joint use is safer for operation and maintenance purposes than dual facilities. It is also safer for the general public. Technical problems, such as interference with communication equipment, can be avoided by this type coordination. Adverse impacts on the environment, land uses, land values, and esthetics are also minimized as is the chance that landowners will be more reluctant or refuse to grant dual rights-of-way. Control points are frequently identical if more than one utility needs to follow a common routing. Finally, without reciprocal contracts, other utilities would refuse to allow cooperatives to attach to their poles.

In the IRS opinion of March 1978 that pole rental revenues are unrelated income, a great deal of reliance seems to have been placed on the Service's interpretation of the definition of "unrelated trade or business" as defined in section 513 of the code. Basically, it is defined as "any trade or business the conduct of which is not substantially related * * * to the exercise or performance by such organizations" of their exempt function purposes. For numerous reasons already referred to, we believe the leasing of pole space is substantially related to the cooperatives' exercise or performance of the purpose and function constituting the basis for their exemptions under 501(c)(12) of the code.

Section 1.513-1(b) of the regulations defines "trade or business" as generally including "any activity carried on for the production of income from the sale of goods or performance of services." Our members have uniformly argued that they are not in a "trade or business" within the meaning of this regulation as the activity is an integral part of providing electric service. Additionally, as pole rental attachment rates are based on a sharing of costs, the activity is not one carried on for the production of income. Essentially, the money received is a mere portion of the expense and any realistic analysis of the rates charged by the cooperatives will find that in most cases the money received does not fully reimburse the system for the actual costs incurred.

It has also been argued by our members that this income is "passi
income as opposed to "active" and, therefore, is clearly not unrela
business taxable income.

NRECA has also met to discuss our members' problems with Gove
ment representatives whose concern is tax policy. It was our impr
sion that they were primarily intereted in two areas: (1) Is this activ
competing unfairly with a taxpaying business? and, (2) In the c
of cooperatives, is one group of members subsidizing another? As
the first of these questions, we believe the answer is clearly, no.
have already addressed this issue today. We also believe that there
or should be, no subsidization issue either; however, we are concern
that this could be a problem if the IRS prevails with its expense me
odologies. REA and other regulators have encouraged fair rental ra
for pole space to avoid such problems as the subsidization by elect
consumers of telephone and cable TV subscribers. The IRS positi
that attachment expenses and rates only apply to a few inches of p
space would imply that electric subscribers should subsidize compani
leasing their poles.

Mr. Chairman, there are many other legal and public interest arg
ments that could have been presented here today. Our members ha
been diligent in their communication on this issue with the IRS. T
cooperatives have submitted many briefs to the IRS. Should the co
mittee desire, NRECA will make available any such documents in o
possession. Among these submissions to the IRS are: (1) briefs th
met with a favorable response from the IRS—that is, pole line attac
ment income was determined to be related and not taxable (2) t
Consumers Power Inc. brief—the lead case in this controversy—a
(3) other submissions that have not yet received determinations fro
the IRS.

In concluding, let me once again reassert NRECA's complete su
port for H.R. 7520. We believe that the unrelated income portions
this bill merely clarify existing law and in no way change it. As pr
viously stated, NRECA contends that the IRS' position on these re
enues is wrong from both a legal and public perspective. The treatme
of pole rental income as member income under this bill is not of gre
significance to our distribution members, as few, if any, are threatene
with a loss of their tax-exempt status due to nonmember income.
would, however, appear to us to be good public policy to treat revenu
from pole attachments mandated both by law and good public polic
as member income.

We appreciate the opportunity of expressing our views and those
our members.

STATEMENT OF MICHAEL BARRY, LEGISLATIVE COUNSEL, NATION AL TELEPHONE COOPERATIVE ASSOCIATION, ACCOMPANIED B ROBERT J. LEIGH, DIRECTOR, LEGAL AND GOVERNMEN AFFAIRS, NTCA

Mr. BARRY. Mr. Chairman and members of the subcommittee, m
name is Michael Barry. I am legislative counsel of the National Tele
phone Cooperative Association. Appearing with me, on my right,
Robert Leigh, director of legal and governmental affairs.

The National Telephone Cooperative Association is a nonprofit trade organization representing over 358 small, rural telephone cooperatives and locally owned and operated commercial telephone systems.

Our appearance today is on behalf of our 247 telephone cooperatives. NTCA wishes to express its appreciation to the chairman and members of the subcommittee for the opportunity to testify regarding H.R. 7520, a bill to amend the Internal Revenue Code with respect to the treatment of mutual or cooperative electric and telephone companies.

Mr. Chairman, I testify in support of H.R. 7520. This bill amends the Tax Code as it relates to telephone directory display advertising and pole-rental income of telephone cooperatives. These same issues were raised in H.R. 5643, as sponsored by Mr. Gore of Tennessee and approximately 120 additional cosponsors.

Telephone cooperatives are in business solely to provide their subscribers the same quality of telephone service that is available to urban subscribers; however, the areas in which these cooperatives operate are so remote, so difficult to serve, that it is most difficult to provide telephone services comparable to those enjoyed in urban communities.

Because of this situation, Congress recognized a need to provide income-tax relief to foster the establishment and operation of telephone cooperatives, and Congress did so under the Tax Code, section 501(c)(12). This section specifically exempts the income of telephone cooperatives "but only if 85 percent or more of the income consists of amounts collected from members for the sole purpose of meeting losses and expenses" in the provision of telephone services.

Telephone cooperatives began in the early part of the century when hundreds and hundreds of non-Bell companies were formed. Cooperatives were organized in the most rural areas where entrepreneurs found the low density uninviting for investment in the telephone business. Many of these systems were technologically crude and were not maintained or improved as the plant wore out or became obsolete.

The rural depression beginning in the 1920's, as well as the electrification of the rural areas in the 1930's, contributed to the demise of hundreds of these cooperatives and other small independents. At the end of World War II less than 40 percent of rural homes and telephone service.

The 1949 amendment to the Rural Electrification Act for the first time provided a sound source of capital for modernization and construction for small rural systems. Today there are 247 cooperatives in 30 States with assets of about $1 billion and annual revenues of $175 million and about 5,000 employees.

Telephone cooperatives serve 768,000 subscribers, which constitute less than 1 percent of the total in the United States. They are, nevertheless, proud of the modern, efficient telephone service which they have brought to areas in which service was believed to be economically unfeasible.

Cooperatives are an important element in fulfilling the congressional purpose of the Rural Electrification Act, "* * * that adequate telephone service be made generally available in rural areas. * * *"

Prior to 1950 all income of a cooperative as a tax-exempt organization, regardless of its source, was exempt from Federal income taxation as long as the profits derived were dedicated to the organization's

exempt purposes. In 1950 the Treasury Department persuaded
Congress that certain tax-exempt organizations were engaging in
related business activity involving unfair competition with taxpayi
entities. These included (1) business activities in direct competiti
with commercial organizations; (2) sale and lease-back arrangemen
and (3) the use of feeder corporations engaged in business ventu
for example, New York University's macaroni business.

The Tax Reform Act of 1950, in section 501(c)(12) exempt
telephone cooperatives. They were, however, in the Tax Reform
of 1969, subjected for the first time to unrelated business inco

In recent years some IRS agents in various States have challeng
two minor sources of telephone cooperatives' income, directory d
play advertisements and pole-rental agreements. Together, these t
categories do not represent more than $100,000 worth of telepho
cooperative income. The costs of audits and litigating these issu
however, has become a burdensome expense. We consider both activit
to be an essential part of telephone service to our cooperative memb
subscribers.

The IRS issued a technical advice memorandum in 1977 whi
determined that telephone directory display advertising is subject
unrelated business income tax. In the classified section of the telepho
directory commercial subscribers are organized according to the
types of business or professions. For an additional charge they m
place an advertisement in the section describing the particular type
merchandise or service offered, providing the contents of the advertis
ment meet the approval of the cooperative. NTCA believes that th
advertising provides information for cooperative member-subscribe
and the cooperative.

Information in the display ads describes the products carried, ser
ices rendered, acceptable credit cards, hours of business and simil
information. Advertisers may be either local merchant/subscribe
such as the drug store, chain grocery store, or plumbing services,
well as national advertisers such as airline companies, car rental com
panies and manufacturers' service centers. The IRS has challenge
the tax returns of several telephone cooperatives and declared th
revenue as nonmember income.

Although the IRS agrees that the director provides useful info
mation and is a convenience to its subscribers, the IRS memorandu
concludes that this advertisement does not satisfy the test of a "su
stantial causal relationship" to the exempt purpose of function
the telephone cooperative.

The IRS has ruled, however, that the printing of the business nam
in boldface in the regular classified listing is within the cooperative
exempt function. The Service rationalizes that "no additional info
mation of a commercial nature is contained in the boldface listing
compared to the regular typeface and the overall size of the two type
of listing is approximately the same.'

We have disputed the reasoning of the technical memorandum r
garding telephone display advertising because we believe that a tele
phone cooperative, like other telephone companies, must provide
telephone directory to their subscribers. It is apparent that telephon
systems could not operate efficiently without an alphabetical an
classified listing of telephone numbers.

Telephone cooperatives do not print the Yellow Pages directories; they are printed by national companies who sell display listing directly to merchants and businesses. These merchants and businesses buy the display ads to assure that the public knows precisely what products or services they provide.

The subscribers depend on this information which actually improves access to telephone numbers and the efficiency of both the telephone system and its directory. For rural consumers, this service is vital due to the limited number of suppliers and the considerable distances between residents and businesses.

Telephone display advertisements in directories are not in direct competition with any commercial organizations. They are a unique service provided by telephone systems which we consider an essential part of our business.

The display listings have been considered by the IRS as regular commercial advertisements if they contain more than the subscriber's name, address, and telephone number.

Mr. STARK. What you are saying is, if a member buys an ad, that still is considered related, that is considered nonmember income?

Mr. BARRY. Some IRS agents have said that.

Mr. STARK. Your members are dealing with a company in Chicago, the directory operation, and you don't publish the directory, is that right?

Mr. BARRY. That is right.

Mr. STARK. You deal with Reuben Donnelley and so you are getting one commission check from Donnelley and they don't have any way of knowing whether they are selling to members or not?

Mr. BARRY. That is right.

Mr. STARK. If a small rural telephone company decided to publish their own directory, there is no problem, would that be correct?

Mr. LEIGH. If it decided to publish its own directory, the case would still be the same.

Mr. STARK. Because it would be billed on their monthly bill and it would not be considered nonmember income; is that right?

Mr. LEIGH. The point of IRS here——

Mr. STARK. Let us get back to my question and we will talk about the IRS later.

Mr. LEIGH. It would be member income from a nonexempt activity. They say that the telephone co-op is exempt only when it engages in telephone service, but printing of a directory is not an exempt activity.

Mr. STARK. Is that Reuben Donnelley complaining that you guys are unfairly competing with them?

Mr. LEIGH. They are our agents.

Mr. STARK. If you printed your own, they would say you are in the book printing business and not in the telephone business and therefore you should not get a tax break to compete with present private initiative?

Mr. LEIGH. We are not asking that.

Mr. STARK. All right. I am sorry to interrupt.

Mr. BARRY. Due to the IRS ruling regarding the directory display ads, cooperatives must apportion their whole directory between related information and unrelated advertising. It does not matter if the advertiser is a local merchant and subscriber or a national advertiser.

Any additional information contained in display advertising is c
sidered taxable and the whole directory must then be apportioned c
linage basis between related information and unrelated advertising
does not matter if the advertiser is a cooperative member-subscriber
not.

All of this revenue is considered nonmember and is aggregated
the 15 percent nonmember test of gross revenues for the basic 501
(12) exempt organization status. Clearly, the small amount of ta
collected from this source does not justify the costs involved in m
ing this determination, nor the impact on telephone service whic
loss of the exempt organization status would imply.

We strongly believe that director display advertisement is a bu
ness-related activity. We believe that this activity is directly rela
to offering telephone service and does not fit within the definition
unrelated business income.

Section 512 defines it as "the gross income derived by an organi
tion from any unrelated trade or business regularly carried on by
less the deductions allowed."

Section 513(c) provides that the term "trade" or "business"
cludes:

> Any activity which is carried on for the production of income from the sal
> goods or the performance of services. For the purpose of the preceding sente
> an activity does not lose identity as a trade or business merely because it is
> ried on within a larger aggregate of similar activities or withn a larger c
> plex of other endeavors whch may, or may not, be related to the exempt p
> poses of the organization.

The term "unrelated trade or business" is defined in section 5

> Any trade or business the conduct of which is substantially related—aside f
> the need of such organization for income or funds or the use it makes of
> profits derived—to the exercise or performance by such organization of
> charitable, educational or other purpose or function constituting the basis
> its exemption under section 501 * * *

As discussed above, we believe strongly that the information
convenience provided by directory display advertising is substantia
related to the telephone business. However, we are more concer
with the IRS rulings which include this gross income with other
related business income.

When revenues from directory display advertisements are added
income, the cooperative may derive from other sources, such as r
from overnight parking of school buses, interest, or telephone-p
rental income, it may exceed the 15 percent nonmember income t
Thus the cooperative would lose its exempt status for engaging
activities that are essential and indispensible in fulfilling its ru
service obligations.

Our other area of concern involves pole-rental income, reve
treated as unrelated business income. Telephone cooperatives, elec
cooperatives and some cable television companies make agreeme
to provide space on their utility poles so that more than one util
service can use the same pole. For the use of this space the teleph
cooperatives receive compensation that reduces the effective ove
cost of installing and maintaining these poles.

Joint use of telephone poles encourages efficient use of right-
way and eliminates the unsightly clutter of poles and wires.

The Rural Electrification Administration, REA, the principal lender of funds to telephone cooperatives, encourages this joint use of telephone poles whenever possible and has issued model contracts for that purpose.

Some of our telephone cooperatives have had their books open for several years because IRS agents have challenged the revenues derived from telephone-pole rental agreements. Cooperatives have been unable to distribute capital credits to their members.

In a national technical advisory issued in February 1978, the IRS determined that pole rentals received by a distribution electric cooperative through its joint use arrangements with telephone companies, telephone cooperatives, other electric utilities and cable television companies are not substantially related to the primary business purpose and exemption functions of the cooperatives under section 501(c)(12) and are therefore subject to unrelated business income tax.

Our cooperatives have argued that the leasing of space on its poles does not constitute a trade or business because it is not an activity carried on for the production of income from the sale of goods or performance of services. Rather, the leasing is a mere cooperative and mutual transaction permitting both parties to avoid incurring certain costs associated with alternative means of achieving the same goal.

The IRS has found that these rental agreements are related to the exempt nature of the telephone cooperative. However, the IRS has determined that the degree of the relationship does not pass the "substantive causal relationship" test under section 513. Currently, there are a number of cases in litigation to determine the "substantial causal relationship."

H.R. 7520 resolves the taxation problems of telephone display advertising and pole-rental agreements in two separate manners: First, it clarifies the congressional intent in the 1954 amendment to 501(c)(12) regarding telephone display advertising. It states that "the sale of display listings in a telephone directory furnished to the members of the mutual or cooperative telephone company" will be treated as member income.

The exemption for telephone cooperatives in 501(c)(12) remains tightly written regarding the requirement that 85 percent or more of gross income must be collected from "members for the sole purpose of meeting losses and expenses."

In other words, H.R. 7520 declares that all income from display advertising in a local telephone cooperative's yellow pages cannot be treated as nonmember income by IRS for purposes of the 85 percent gross revenues test.

By so designating the display and revenues, the 501(c)(12) status of the telephone cooperative is not endangered, while the IRS may continue to collect tax on that unrelated business income as provided in section 512.

Income derived from telephone-pole rental agreements is treated in the second part of the bill. The bill adds a new subsection to section 513 of the code for unrelated business income:

> **Certain Pole Rentals**: In the case of a mutual or cooperative telephone or electric company described in section 501(c) the term "unrelated trade or business" does not include engaging in qualified pole rentals as defined in section 501(c)(12)(D).

The bill states that the pole in question is used for "providing tel phone or electric services to its members—and in connection with th transmission by wire of electricity or of telephone or other commun cations."

NCTA believes that the approach taken in H.R. 7520 in resolvin these problems is a reasonable one. Since telephone cooperative incom from directory display advertising and pole rentals is only abou $100,000 nationally, the bill would resolve numerous cases in litig tion and free IRS agents to pursue other tax matters.

We believe, Mr. Chairman, that Congress never intended to jeop ardize the viability of telephone cooperatives by terminating the tax-exempt status because of the income in dispute in these tw categories.

Telephone cooperatives are essential to rural Americans who liv in areas where commercial telephone interests found it uneconomic to serve.

We support H.R. 7520 because it will clarify the intent of Congre regarding the status of telephone display advertising and pole-rent revenues.

Our cooperative will be free from the burden of expensive an time-consuming audits and litigation and will be able to devote the energies and resources to providing quality telephone service to th rural subscribers they serve.

We ask the members of the subcommittee to support the legislatio

We thank you for the opportunity to present testimony on th important matter to our telephone cooperatives.

Mr. STARK. Thank you, Mr. Barry.

And, Mr. Gay, did you have some testimony?

STATEMENT OF HEYWOOD C. GAY, EXECUTIVE VICE PRESIDENT GEORGIA ELECTRIC MEMBERSHIP CORP.

Mr. GAY. I have a very brief statement I would like to make.

Mr. STARK. Will you proceed, please?

Mr. GAY. My name is Heywood Gay, executive vice president of th Georgia Electric Membership Corp., which is a statewide associatio for the rural electric cooperative in Georgia. Our member systems serv 73 percent of the land area of Georgia, with 93,000 miles of lines 700,000 meters.

I am here to testify in favor of Chairman Ullman's bill, H.R. 752 and ask other Members to support it.

Our Georgia House delegation and two Senators have all spoke in favor of the intent of this legislation.

As you know, Representative Gore, Democrat of Tennessee, prev ously introduced a similar bill, H.R. 5643. We were successful getting all 10 Members of our House delegation to cosponsor th Gore bill. These included nine Democrats and one Republican.

In addition, our senior Senator, Herman Talmadge, has introduce a bill in the Senate which is identical to Chairman Ullman's, and ou understanding is that our junior Senator, Sam Nunn, has becom a cosponsor of that bill.

This unanimous support from our Members of Congress indicat the strong feeling that exists in Georgia on this matter. I will te you another reason why we have such strong support. Rural electric cooperatives have built pole lines that are paid for by member-consumers with the assistance of loans from the Rural Electrification Administration. If any profit or margin is realized from electric service, it is returned to the member-consumers. We believe this is a vital public service done on a nonprofit basis.

Now comes the Internal Revenue Service to say any revenue derived by these cooperatives for pole line attachments constitutes unrelated business income and thus is asking the nonprofit cooperative to pay taxes on this revenue. As most of you know, most of these lines are built across prairies, fields, and woods, with but few customers to the mile. If a telephone company also serves these customers, it makes little economic sense to build another pole line and not jointly use the same poles. Likewise, landowners and environmentalists will rightly object to two poles where one will suffice.

Most of the alleged "unrelated business income" comes from telephone company rentals. We believe reliable telephone service is not only good for the economy of an area and helps maintain a higher standard of living, but it is also extremely important if we are to provide reliable electric service.

Problems on a cooperative's distribution system or outage reports are practically all reported over the telephone. With the absence of telephone service, it might be days before individual outages would be corrected. For this reason alone, we believe the Internal Revenue Service is not justified in its claim that these revenues constitute unrelated business income.

Members of the committee, we believe the solution to this problem is a legislative one. If you approve and eventually pass this bill, it will resolve our problem. If you elect not to approve this bill, we will be left with the long, expensive, and uncertain route of judicial relief. We have already had a taste of the judicial route and believe legislative relief makes more sense and would cost our consumers less.

Our legal counsel profoundly advises us the IRS assertion is clearly illegal, but to sustain this view in the courts will be very expensive.

This is a problem that every rural electric cooperative in the country faces, but in Georgia alone, IRS is already asking six cooperatives to pay $171,827. We have 10 others audited but not yet billed. We don't feel this is right. We don't feel it serves the public interest. Our entire congressional delegation agrees with us, and we respectfully ask for your favorable consideration of this legislation.

Mr. STARK. Thank you, Mr. Gay.

I am just trying to sort this out, and perhaps you gentlemen can help me.

I think there are two issues in H.R. 7520 and I am not sure which one is more important to your industry.

There is a question of how much revenue the Government collects. I think that is perhaps secondary. I think the question has been—and I have always been a great supporter of cooperatives and I was raised in the shadow of the La Follettes in Wisconsin where the movement started before any of us were born—I think the danger is, that like mutual savings banks and credit unions, like the Navy Credit Union—

they are getting to be so big that they really aren't, in my book, cooperatives anymore. They are like the mutual insurance companies; they are big businesses and their executives enjoy munificent salaries and they have all of the bureaucratic incentives to expand, like happens in Government. I don't know where the distinction is between a truly rural co-op to bring communications or power to places where it might not otherwise be, and those others. So it is my feeling that the 15 percent was imposed upon your industry by the for-profit competitors who said, "Hey, we don't want a tax break for someone who is going to compete with us and have 10 percent members and 90 percent customers, and we have a tax-free entity out there competing with us. That is an unfair advantage."

So, I would say the 15 percent was rather an arbitrary figure set at some point in the history of the tax exemption for cooperatives; is that correct?

Then you further assume that some of your members are bumping up against that 15-percent limit, or a lot of H.R. 7520 would be unnecessary. If nobody had any nonmember income to speak of; it wouldn't make a lot of difference. Is that a fair assumption?

If someone only has 1 percent nonmember income, you don't care, and you have a lot of room for some other nonmember income. Is that a fair statement?

Mr. PARTRIDGE. Actually, we have very, very few coperatives which are subject to Federal corporate income tax because of the 15-percent proviso. Most of the distribution cooperatives do indeed serve only their consumer members. Very few—and it is a most exceptional thing—serve other than their members.

Mr. STARK. But the distributive ones, for the smaller ones, H.R. 7520 isn't necessary. Are there half a dozen in the country that really need this kind of legislative relief?

Mr. PARTRIDGE. I know of no distribution cooperatives. Maybe there are a few generating cooperatives and perhaps some telephone cooperatives that are bumping the 15-percent limit.

How many would you think there are?

Mr. LEIGH. We are arriving pretty close to it.

Mr. STARK. How many of them are there, and how many——

Mr. LEIGH. There are 247 throughout the Nation.

Mr. STARK. How many are hitting the 15-percent limit?

Mr. LEIGH. About 15 of those don't have a tax exemption, and I would say that the others, maybe 100 of them, come prety close to it.

Mr. STARK. So your problem is somewhat different from the power co-ops, and then there is the third group?

Mr. LEIGH. The directory advertising problem is different than the pole rental problem, because we want to pay tax on the directory.

Mr. STARK. No one is addressing the wheeling problem here, and I have another feeling about that. The wheeling problem, I assume, hits the generating or bigger co-ops, is that right?

Mr. PARTRIDGE. It affects some generation and transmission cooperatives, because of joint participation in these power projects. The size of these projects requires joint participation, as does public interest and the economics.

Mr. **Stark**. For that particular group on wheeling, if in fact the distributive and generating co-ops have enjoyed tax exemption, which someone like P.G. & E. does not, that means that for the generating co-op in Georgia or Oregon, my taxpayers in Oakland are paying a little more taxes because we are giving exemption to a large co-op in another State or in another area.

Somehow, if the wheeling proposition affects my constituents—and you guys aren't the wheel-free part of it—because you who are large generators and distributive co-ops, then you are already getting some tax advantage that your profitmaking brethren are not. The wheeling thing can't really cost you anything and you are merely a link in a network.

Now, to the extent that there are some actual out-of-pocket costs for wheeling, I suppose that is true; but I am trying to sort through.

You have three kinds of different groups here hanging on one bill. My inclination is to say that maybe one of the ways to deal with the directory problem is to get out of the whole income-taxing thing—I feel the same way about profitmaking utilities—and make you pay some kind of excise tax right out of the income or sale or gross sale of the directory.

Then you could go ahead and chunk it into your operating income any way you want. If you would sell advertising to a member, the member would not pay that tax. So if we say a 10-percent tax, your members get a 10-percent rebate—if they are members who buy directory advertising, and if they don't, you pay 10 percent. You don't worry about it. Now let's get back to the pole rental.

What part of the pole or the pole maintenance do you charge to the cable television people, and what part of the pole rental do you charge to the telephone company, and why not just say, or why wouldn't it be simpler to say, or to keep you from competing with the profit people, you have to pay an excise tax on that part of the income that is either nonrelated or nonmember, and then not tax you at all?

That is kind of the way I would look at this as being the fairer and easier thing for everybody to deal with, if it is valid, that there must be a distinction between the co-ops who are doing noncooperative stuff, selling to nonmembers, or selling services that are directly competitive with their taxpaying competitors.

I am just afraid that this bill is dealing with three different groups in three different ways; and I am uneasy about it.

Now, you can address my fears any way you want.

Mr. **Partridge**. First of all, if I may respond, this bill would not really impact on the generation and transmission of cooperatives. It is difficult and I think impossible to compare the relative tax advantages of the cooperatives, the publicly owned systems and the investor-owned systems.

For example, we do not have the advantage of the investment tax credit.

Mr. **Stark**. We are trying to take care of that for you. If you will support me, we will fix that. I have 5 minutes to vote and my colleagues, Mr. Duncan, or I will return when we recess.

[Brief recess.]

Mr. **Guarini** [presiding]. We will come to order.

I am informed by counsel that there are a few questions that th committee would be interested in, and I would like to take the libert of having you respond in writing to a few of the questions we ma propose. Then we will enter them in the record, so we will have complete record.

But if any of you gentlemen want to augment or make any furthe comments while you are here at this time, you are at liberty to do s

I will ask each of you if you would like to sum up your position o add a point that has not been covered by Mr. Stark in his examination

Mr. PARTRIDGE. As I stated in our testimony, we very strongly believe pole rental income to be related income. This income is now bein treated by IRS as unrelated income. That is the basic issue which ha brought about this problem. We think that the moneys received fo pole line attachments are indeed related to the principal purpose o the business of providing electric service in the rural areas. We do se a need to resolve this matter promptly, otherwise it will drag throug the courts for many years.

We really cannot assess at this point the financial impact on the cooperatives, because these cases are only beginning to be dealt with by IRS.

In the first instance that I mentioned, Consumers Power of Oregon, the amount that they were required to pay under protest was some $15,000, but that is only the beginning, and from that point, because almost every electric cooperative in the country has pole line attachments, it could become a very sizable tax burden to our consumer-members.

Mr. GUARINI. There is a continuously growing cooperative enterprise in the United States; isn't that correct?

Mr. PARTRIDGE. Well, our rural electric cooperatives have not changed in numbers in recent years. We do have a growth of new consumer-member meters on our rural electric lines annually. Our total service across the country is increasing. That is, something between 250,000 and 300,00 meters per year, typically, but the number of cooperatives is essentially stable.

Mr. GUARINI. But the membership within the cooperatives is accelerating continuously?

Mr. PARTRIDGE. It continues to grow and they serve about 9 million meters.

Mr. GUARINI. Are there any other estimates?

Mr. TILLMAN. I really can't add much here, except that as Mr. Partridge indicated, the primary concern of the rural electric systems has been the unrelated income issue. We believe very strongly that pole rentals should not have been declared unrelated income and we note that the Treasury Department seems to have agreed with us today in their comments.

Mr. STARK. I guess I have an idea. I was talking to the staff about your feelings to my question when I had to go and vote. I am perfectly willing to see two things done: I am perfectly willing to see your tax accounting simplified, and that is why I like the excise tax, because it is simple and I don't suggest that is a way of raising revenue. I doubt if many of you pay very much income tax and I doubt if there is much loss to the Government. But if we took that revenue and spread it around, I would imagine the excise tax would be pretty small.

Then the other side of the coin is, how do we give you a competitive advantage to make up, to answer the question of the profit power companies who ostensibly pay taxes? The fact is they don't even pay taxes. The whole gas and utility industry doesn't pay $500 million a year in taxes. We give them so much in unneeded and unnecessary depreciation and then we let them bill their customers on it, and then set their rate base on it, which, to me, is unconscionable.

Some pass it through and some don't and you have heard all of that.

The fact is it is not a big revenue raiser for the Government when you consider the size of the industry and its gross income. It has not been as profitable in recent years as it was once. But if we could somehow—and I think you gentlemen who accept the tax, there has to be some difference to keep your cooperative status, which is tax exemption.

I have had a bill in for years, literally, to make electric utilities and the telephone and the gas utilities tax free and just set an excise tax on usage. I don't know what that would do to the co-ops. It would take away some of the advantage, accept the fact you would be rebating to them. Then we don't have to argue. You have stockholders or you have cooperative owners, as most of you do. But now, as long as the income tax becomes the real reason to stay cooperative, I assume that is the only reason, to protect that cooperative status. Do you lose anything else besides the tax-free exemption if you get classified as a profitmaking company? Is there any other advantage in being a cooperative other than the tax-free status?

Mr. **Leigh**. I can't speak for the electric industry, but for the telephone industry the tax advantage costs us money.

Mr. **Stark**. I am sure it does.

Mr. **Leigh**. It does, because the Bell System files the toll rates and if we were a taxpaying entity they would have to pay us the income tax. They do not do that today, and so our tax advantage is spread over all the telephone users throughout the country.

Mr. **Stark**. What I am getting at is, if the reason you are tax exempt is that 15-percent number, I think as you are all seeing the distributive people, you are going to have cable television and microwave transmitters and a host of people as the communications industry and the power industry get more sophisticated, and they are going to want to use your network. Somehow, I think this bill isn't answering all of the questions. I think if there is an amount of nonmemberships income you can have, let us set the amount. Then let us set some penalty which then will make the profitmaking people happy, because it forces you to some extent to stay truly a co-op.

I just would say I think we are climbing up the wrong pole or answering the wrong phone here. I can see where it helps some of us, but there is no real sense to it. That is 15 percent; that is just a number that we might as well throw a dart at the board.

Our committee should be concerned with raising revenue. We aren't going to raise much revenue, and the principal concern that I submit is being addressed here is to keep peace between you and the profitmaking people. The Tax Code is a cumbersome way to do that.

If you really feel what we are doing, we are putting some tax penalties on you to keep the Bell System happy and to keep P.G. & E. happy, so they don't think the rural cooperatives are cutting unfairly on their turf. I think that may have been an issue back in the 1930's and 1940's, but I don't think so today.

I would urge you guys to go back to your members and see if there isn't a different way to do it. This bill may pass. And the staff, by the way, would like me to suggest and ask you if they could submit questions to you and ask you to respond in writing. They would like some information in aggregate figures, in numbers of members affected, and percentage of income that would come from pole rentals and other things. If you would respond to those as best you could, we would appreciate it very much, and we could shorten the hearing today.

[Responses to questions follow:]

NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION,
Washington, D.C., July 17, 1980.

Mr. JOHN J. SALMON,
Ways and Means Committee,
Longworth House Office Building, Washington, D.C.

DEAR MR. SALMON: I am writing in response to Congressman Rostenkowski's letter of July 2, 1980, setting forth a number of questions he would like to have answered. Much of the information requested is not readily available to us and has required that we survey our members in an effort to be responsive. Set forth below are our answers based on the data we were able to compile:

(1) Our membership is composed of 900 distribution cooperatives, 59 generation and transmission (G&T) cooperatives, and 69 others (this includes statewide organizations, G&Ts which act only as power acquisition agents for their members, but produce no power, credit unions and several foreign electric cooperatives.

(2) The average dollar value of the distribution systems based on 924 REA borrowers with "total assets and other debits" of $10,141,308,093 is $10,975,442. The distribution systems range in size from the Chugach Electric Association, Inc., in Alaska with "total assets and other debits" of $182,874,020 to Swans Island Electric Co-op in Maine with assets of $372,181. It should be noted that Chugach includes some G&T plant and equipment. Figures for G&T cooperatives are not included since they are not impacted by HR 7520.

(3) The only member electric cooperatives we are able to determine are at the 15 percent nonmember income ceiling are several G&T cooperatives that are unaffected by H.R. 7520. We were unable to find any distribution systems at the 15 percent nonmember income ceiling or approaching it. Most of those surveyed indicated that their nonmember income falls below 5 percent. The only distribution systems we were able to find that have ever been threatened with a loss of exemption were several that had sales of plant and/or equipment in one year giving them large nonmember income revenues. Such cases have resulted generally where areas or territories served were incorporated or changed forcing a sale.

(4) The predominant sources of nonmember income are interest drawn on funds invested by member cooperatives and pole line attachment revenues. The bulk of this is interest income. Even though specific figures are not available for rural electric cooperatives, our informal survey seems to indicate an average of no more than 25 percent of nonmember income is derived from pole rentals. The amount of revenue derived from the transmittal of power by distribution systems for other utilities is infinitestimal. G&T cooperatives derive such revenues, but they are unaffected by HR 7520.

We hope that the above answers are responsive to your questions. Should you desire further information, we will be happy to comply with your request.

Sincerely yours,

ROBERT D. PARTRIDGE,
Executive Vice President and
General Manager.

Mr. GAY. I have one specific thing I would like to respond to. I can address only the situation in Georgia, and Mr. Partridge will address the national situation.

I hope you are not saying that you need to put something else on us? I hope you are saying we need some relief.

Let me give you a very specific example in our State: Our investor-owned companies charge in their rate base so many dollars and the State commission grants them those dollars in the rate base. I did not invent the term but it has previously been called "phantom taxes" for which they collect from the consumer and put on the table in a pile, if you please.

At the end of the year, if they were to take out of that pile and pay those taxes for which that money was collected, that pile would still be rather large.

We do not enjoy any type of advantage like that.

Mr. STARK. Do any of your members pay any significant income taxes?

Mr. GAY. No.

Mr. STARK. I don't know really why you are here. I don't mean to put anything tougher on you, because all I am interested in, in this committee, is collecting revenue, and I don't think we get much.

There are people, wonderful people, running those, but they are not a big revenue source for us. The issue is between you and the profit-makers in Georgia; that is not really a tax issue. They want the tax on you to protect themselves.

Mr. GAY. Let me give you another example.

Mr. STARK. Is that right?

Mr. GAY. I do not see it at all that we have a problem with the investor companies on this issue. I don't think that is the issue here. Our problem is with the Treasury.

Mr. STARK. Why is the Treasury pressuring you to pay taxes? Are they coming after your pole rental because they think they are going to balance the budget with the taxes you are paying? No; there is pressure from either the people competing with you in the yellow pages business or people who feel you are getting this great advantage by being tax free.

As a kid, I read all of the ads: "The investor-owned companies are paying their fare share." They were talking about you guys when they wrote those ads. I don't believe them. I never have believed them, and the co-ops are coming back and talking about the strengths of rural America. I think you are both right, but I think this idea of batting the tax thing, it doesn't make much sense, really.

There ought to be a better way to preserve your cooperative nature, if you will, and protect the profits from unfair competition, and if we need revenue we will come in and charge a little excise tax on everybody. It won't amount to more than a half a cent or something like that.

I am either urging you to get broader legislation that defines that you won't pay any tax, and define somehow when the penalty is something different. This doesn't seem to be of great magnitude for your industry, except that it may keep you out of offering new services and I don't want to do that.

I think you should be able to offer services to your customers, whether directory advertising or computer terminals or princess phones; you ought not to be penalized just because you are members of a co-op. But to the extent that somehow sometimes that was considered non-co-op income, you have a problem.

You may not pay enough tax on that to even pay your expenses to come here and testify when all is said and done, but if it is necessary to do that, politically I would think a little excise tax would be better rather than getting into this question of how you allocate costs.

It would be simpler if it preserved the idea that you have to preserve. We are doing it the wrong way.

The staff will forward some more pertinent questions in writing to you and give you the opportunity to respond in writing, to serve your members as you have so well today.

Mr. PARTRIDGE. We will be very glad to respond to any questions or supply any information that will be useful to the committee.

I know of no effort on the part of the investor-owned utilities which would have brought about this action by the IRS. As you noted eariler, the fact is that the investor owned utilities are not paying much in the way of taxes today. We, in fact, as wholesale customers of the investor-owned utilities, pay a component of whatever tax they collect. The rural electric cooperatives buy more than 30 percent of their electricity from investor-owned utilities.

Our rates at best, I think, nationwide today are a bit higher than those of the investor-owned companies, for a number of reasons, primarily because of our low density and our high investment.

So we do have certain disadvantages and those disadvantages are compounded by what we think are unrealistic assessments by IRS of pole attachment revenue, an assessment which we think the Congress never really intended at all. That is why we thought best to seek a legislative remedy on the matter.

Mr. STARK. Thank you very much.

Mr. GAY. The only closing statement I would like to make would be, as Mr. Partridge has done, add a little urgency to the legislation. We have six systems that have been billed for $171,000 for the years of 1976, 1977, and 1978. We have 10 others that have been audited and they are anticipating a bill.

Mr. STARK. Most of this is coming from what?

Mr. GAY. This is coming from pole line revenue. We have two systems that have been billed for $60,000 each. This is a significant thing.

Mr. STARK. With those bills, is that almost half of the gross revenue, or are they saying there are no expenses?

Mr. GAY. That is where they would start, and then if we call it the threshold question, if we can't prevail there, we have to argue about 6 inches and 4 feet and where are we on the pole?

Mr. STARK. It may well be that we ought to collect some tax from you if we are collecting it from your investor-owned counterparts. I would have to look at what is equity there, because if you can sell that service, and if I am running phones lines or cable TV lines to a community or to a couple of counties and there is an investor-owned utility and a co-op, and I am getting 10 cents a pole cheaper or paying the same amount, I don't know the differences there, I think for all of us to go through this charade of trying to figure out what the costs are of maintaining poles relative to how much line you are hanging up there, it makes no sense to me at all.

I agree with you. Maybe I shouldn't and that is why I came back earlier, and maybe we should charge co-ops. I wish we had some of the investor-owned people here to see what their objection would be to letting you go free.

The IRS, I expect, is just obeying the rules and they are good. We ought to be thankful for that. We ought to be looking at the rules that created this monster and I don't think they ever intended or anybody ever thought about cable TV or phone companies wanting to use electric poles. The history of this is to protect investor-owned utilities from the great advantage of tax exemption that was given to you all.

Mr. GAY. The situation does change. For years a number of systems in Georgia sold appliances simply because there was nowhere else for those rural consumers to get a refrigerator and in some cases they actually financed them with it.

Mr. STARK. I suppose gas companies still do.

Mr. GAY. I couldn't comment on that.

Mr. STARK. We have about 6 minutes to vote. Does anyone else want to add something?

Mr. BARRY. Just that we would be happy to answer any questions.

Mr. STARK. Thank you, and we will call the next panel, and we will be back in a moment. We will recess at the call of the chairman.

[Brief recess.]

Mr. STARK. We will reconvene and we will proceed.

The next witnesses are Mr. Edward Sanders, president, Allied Plywood Corp., and Mr. Norman Kurland, president of Norman Kurland & Associates.

Do you both have testimony?

Mr. KURLAND. Yes.

Mr. STARK. Without objection, we will place your complete statements, which we have copies of, in the record and you can proceed as informally as you want to convince me of the need to amend the provisions of the ESOP plans, whoever wants to go first, just proceed.

STATEMENT OF EDWARD H. SANDERS, PRESIDENT, THE ALLIED PLYWOOD CORP.

Mr. SANDERS. If this statement is going into the record, in that case I will summarize.

Mr. STARK. It will, Mr. Sanders, and it is our general procedure to put all of them in the record and any additional remarks that you add, the reporter will take down and that will also appear in the record. So if you don't want to read it, you get in twice as much in half the time.

Mr. SANDERS. It is rather late, and in that case I will read the first paragraph only, and I might say that the whole subject to me is so important that I hope the members of the committee will read these statements and give them attention as soon as possible.

My name is Ed Sanders and I am president of Allied Plywood Corp., of Alexandria, Va.

I am testifying in favor of H.R. 7606 which was introduced b Mr. Kostmayer and Mr. Nowak into this committee.

This bill would amend the Internal Revenue Code to provide fo the nonrecognition of gains on the proceeds from the sale of sma business stock to an ESOP if such proceeds are reinvested within a 18-month period in other small business stock.

I know of no measure now before Congress that would be more beneficial for the growth of small businesses in the United States.

That is the first paragraph and now let me just speak extemporaneously.

I am involved in this subject and what I think some of the result of the present tax law are.

I started this business of mine 29 years ago. It has been quite successful. I have reached the point where I have to retire. I have to ge out. So the question then arises, it is a regulatory corporation and have a controlling interest and controlling stock.

There are two ways to get out of a corporation if you are a majo stockholder and if your stock is not traded on an exchange:

One would be to sell the stock for cash to anyone who wants to bu it, including the employees. In that case you have capital gains ta which takes away your equity.

The second method is to merge with a large corporation, in whic case you simply exchange stock with a larger corporation and retai your entire equity to work for you as an investment for the rest o your life. This is an extremely important issue; it is one of the mos important reasons why mergers take place and why small businesse get acquired.

I think this is a serious problem in the country and this bill, H.R 7604, would solve the problem for small businesses like mine an thousands of others by allowing the owner of most of the stock to sel it to an ESOP trust, and the cash received then is used to buy othe equities without tax penalty. In other words, the results are the sam as would occur in an acquisition or merger.

I believe that is all I would like to say at this time. It is a little late

Mr. STARK. Mr. Sanders, if I understand you correctly—I sold a business when I came to Congress and paid capital gains, as I recall and I think it was 37.5 percent, and I am still smarting under that one.

If I sold the stock to an ESOP rather than to a bunch of Arabs like I did, I could have reinvested in another small business.

How would you define the "other small business"?

Mr. SANDERS. I would take the cash and then simply buy other equities, and I don't see that they should have to be a small business. I guess the money received would go into capital producing business.

Mr. STARK. Unless you can figure out how I could get my money back, I would be mean enough to say I had to pay mine and everybody else ought to pay theirs. I have been intrigued with the idea of postponing capital gains or even waiving capital gains if you could find a way to isolate those investments that are truly new business. ESOP doesn't do that; it perpetuates an old business. But for the entrepreneur who actually creates a business and not the corporation who buys someone else's business, I think we should encourage those new enterprises. That tends to be riskier than established ones, which if they are successful could generally create more jobs.

That is why it would not seem right to me in the national interest really to allow people to invest and reinvest. We might as well eliminate the capital gains tax. That makes some sense.

If we could get some minimum tax, I would probably support that. I would probably support eliminating the capital gains tax completely, and put some kind of a cap on ordinary income tax, much lower than it is now, say 30 percent, and have no capital gains; but also have a minimum, and get somewhere.

There are still people, you and I know examples and we may have been involved, where people pay no taxes. A lot of industries do that. There are guys in the oil business.

I must state for the record that H.R. 7604 is not the subject of the hearings and as a matter of fact you are welcome and I appreciate your taking the time to bring us your own story. But we had an agreement with the other body to confine our hearings here today to Mr. Ullman's bill, H.R. 7606.

Your statement will still appear in the record and I am sure the staff will refer to it at a later date.

[The prepared statement follows:]

STATEMENT OF EDWARD H. SANDERS, PRESIDENT, ALLIED PLYWOOD CORP.

My name is Ed Sanders and I am the president of Allied Plywood Corporation of Alexandria, Virginia. I am testifying in favor of H.R. 7604 which was introduced by Mr. Kostmayer and Mr. Nowak into this committee. This bill would amend the Internal Revenue Code to provide for the non-recognition of gains on the proceeds from the sale of small business stock to an ESOP if such proceeds are reinvested within an 18 month period in other small business stock. I know of no measure now before Congress that would be more beneficial for the growth of small businesses in the United States.

Let me first describe our company and the reasons why thousands of small businesses like ours would benefit from the adoption of H.R. 7604. Allied Plywood was founded 29 years ago and wholesales plywood and related items in the Washington area. Last year we had sales of just over $8,000,000. We have lived through just about all the problems that a small business can have and feel that many of the problems are solved when employees are given the opportunity to acquire an equity in the business where they work and to share in the risks and rewards of their enterprise.

We have had an Employee Stock Ownership Plan for three and one half years now and the trust at present holds 43 percent of all outstanding stock in Allied. It has been my intent to sell my stock interest to the ESOP trust over a period of years so that eventually the employees will be able to take over and continue the business. Whenever I sell some of my stock to the ESOP trust the proceeds are subject to capital gains tax and it is difficult if not impossible to invest the balance so that the return can match that of my original equity. My alternative is to merge with another corporation. In the case of a merger my stock would simply be traded in a tax free stock exchange with a larger corporation and my entire capital would continue to earn a fair return. You can imagine how a merger might affect my employees and you can understand one reason why large corporations get larger and why small corporation get acquired. Just consider this inequity: my own employees with their own savings cannot compete with a large corporation in acquiring my equity in their own place of work. And in the case of a merger, the stockholders of a large acquiring corporation would be less likely to have a personal interest in the employees. This illustrates a tax incentive for the concentration of industry. Capital gains tax acts like a glue to keep capital from moving where it is most needed. The Internal Revenue Service becomes an immediate partner in any movement of capital.

A solution to this problem is now being considered. The Kostmayer-Nowak Bill H.R. 7604, which provides for a tax free rollover only for small business stock sold to an Employee Stock Ownership Plan, is a conservative step in the right direction. It would not only promote ESOP's but it would help to free capital to be used where most needed. There are literally thousands of small corporations like Allied Plywood that would jump at the chance to help their own employees become stockholders and at the same time create a tax deferred market for the stock of all employees through an ESOP. The Kostmayer-Nowak Bill can turn glue into oil. I believe that the cost of deferred tax revenue would be far outweighed by the increase in capital and jobs in the small business sector. And this is where most new jobs come from.

Now for a moment, think about our employees. Without an ESOP few of them would acquire stock in our free enterprise system. Thousands of ESOP's are never formed because taxes must be paid when outside stock is sold to an ESOP trust. Why should not employees be able to have a "piece of the action" just as easily as another corporation can via merger? Their opportunity to do this is impaired by the reluctance on the part of present stockholders to form an ESOP in the first place. Now here is another matter to consider since new equity capital is so vital to our economy. Under a tax deferred exchange system for ESOP's every dollar contributed to an ESOP trust would represent new capital investment. Every dollar used by the trust to buy authorized but unissued stock would represent new equity capital. Also, every dollar used by the trust to buy outstanding stock would result in new capital formation if this dollar were reinvested in another small business. Such a system would be a vast improvement over a corporate merger. To encourage mergers is only to encourage larger corporations with no added tax revenues and no added new capital. Most small corporations are composed of stockholders who are "locked in" and to sell their stock is to lose a great deal of their investment in taxes. Why should employees in an employee owned corporation not enjoy the same conditions that corporations now share with each other?

The Kostmayer-Nowak Bill H.R. 7604 answers these problems. This bill does not involve transfer payments of revenue. It does not involve tax exemptions, only deferral. I believe that proper study would show that the increase in corporate and individual taxes would greatly exceed the cost of deferred taxes. Primarily this bill encourages the accumulation of capital producing property in the hands of the average worker and this is the most distinguishing economic difference between a free enterprise and a socialist society.

Mr. Sanders. I have no objection to the remarks you just made.

Mr. Stark. I would like to simplify the tax code and I did pay substantial capital gains and literally 2 years ago I am back here watching them lower the 25 percent. You hate to see it go; it would be much nicer.

Mr. Sanders. Why didn't you merge with some larger company and avoid all of that tax?

Mr. Stark. Quite frankly, the guy who bought my business, which happened to be a bank, paid so much for it that no other banker in their right mind would have paid that price. It was almost worth selling it for cash. I figured I didn't want to be a partner in a tent-manufacturing company.

Mr. Sanders. My only object is to offer an alternative to a merger.

Mr. Stark. Mr. Kurland, did you want to proceed?

STATEMENT OF NORMAN KURLAND, PRESIDENT, KURLAND & ASSOCIATES, WASHINGTON, D.C.

Mr. Kurland. Congressman Stark, I would also like to include an article that supplements my statement, which gives the philosophy behind it, and I think amplifies the points of my statement.

If I could submit that also for the record.

My name is Norman G. Kurland and I appear before you today in my personal capacity as a Washington lawyer and head of a Washington-based ESOP investment banking and corporate finance consulting firm. I am also a member of the ESOP Association of America, a San Francisco-based national association of over 300 employee-owned companies with over 1 million employee owners scattered throughout 45 States and Puerto Rico.

I am most honored to have been asked by the ESOP association to announce their support for two companion pieces of ESOP legislation—H.R. 7606, the Employee Stock Ownership Improvements Act of 1980, and H.R. 7604, a bill to permit a tax-free rollover for the sale of small business stock to an ESOP if the proceeds are reinvested within 18 months in other small business stock.

I am also pleased to have the opportunity to testify in favor of both of these extremely important and timely pieces of legislation. I want to concentrate my testimony on H.R. 7604, the ESOP small business rollover bill which was introduced on the same day last week as H.R. 7606, by Representative Henry Nowak and Representative Peter Kostmayer. From every standpoint it is perhaps the most significant ESOP bill that is now before the Ways and Means Committee.

For reasons I will explain after commenting first upon H.R. 7606, I strongly urge you to expedite the scheduling of a hearing on this highly innovative rollover bill. It offers an exciting and relatively low-cost shot in the arm to small business development.

THE EMPLOYEE STOCK OWNERSHIP IMPROVEMENTS ACT

First, let me comment briefly on H.R. 7606, the Employee Stock Ownership Improvements Act, sponsored by the distinguished chairman of the House Ways and Means Committee. It contains mostly a series of relatively minor technical amendments.

The most controversial feature in the bill is the deletion of the limited voting passthrough requirement that was added by the Revenue Act of 1978 as section 401(a)(22) of the Internal Revenue Code.

What is involved in this issue? How does it actually affect related issues of corporate control, worker participation in corporate decisionmaking and management accountability? The truth is, at least to date, the mandatory passthrough, to my knowledge, has had no practical impact on how workers relate to their companies.

Why? Because the mandatory voting passthrough is extremely limited in its scope. It affects only closely held companies with leveraged ESOP's, TRASOP's and other defined contribution plans holding more than 10 percent of their assets in company stock. It is required only on issues of major importance that, by State law or charter, must be decided by more than a majority vote of outstanding common shares voted, such as mergers, liquidations, and sales of total assets. ESOP participants then vote only those shares that have been allocated to their accounts.

In contrast, ESOP's holding company shares that are regularly traded in the market must pass through voting power on all corporate issues on allocated stock. Before the mandatory passthrough was added in 1978, voting was discretionary and varied from company to company. In companies with unions, the voting rights of ESOP participants have always been a negotiable issue.

Reasonable people can argue from various sides of this issue. Personally, I favor full voting passthrough——

Mr. STARK. That is the law now. In other words, if your company has a union contract, you can have an ESOP without passing voting power through if you bargain that with the union; is that right?

Mr. KURLAND. That is exactly right. If you have stock that is not publicly traded and the union doesn't negotiate and say, "We want you to pass through the vote," it doesn't have to be passed through. If the union decides and bargains with management and says, "We think it is a good idea for you to pass it through and we will give you this if you will give us that," then it can be passed through to the individual employees. The stock in an ESOP is held, as you know, in a trust.

Mr. STARK. I am familiar with them.

Mr. KURLAND. So it is a question of whether a proxy right will be passed through to the individual participants.

Mr. STARK. Thank you.

Mr. KURLAND. I am convinced personally that, as employees begin to accumulate a substantial ownership stake and thus have something to defend, employee-owners will begin naturally to demand even greater rights of ownership participation than are today enjoyed by other stockholders. Many companies already voluntarily pass through voting proxies to their employee-owners.

On the other hand, most closely held companies in the ESOP Association, including several closely held companies I have worked with, treat voting power and other issues affecting control with extreme anxiety. Most ESOP's are still new and the ownership-sharing philosophy that surrounds a quality ESOP does not take root overnight.

The traditional "we/they" barriers that a well-designed ESOP is intended to overcome do not suddenly vanish. Participation is a process in opening up new two-way channels of communication, a way of gradually building trust and confidence among people with widely divergent experiences and mind sets.

Participation is not something that can be ordered or forced upon parties by Washington. It involves trial and error and a delicate balancing of principles of accountability with principles of continuity of the enterprise. In the final analysis and for the benefit of all parties, the company must work. ESOP or no ESOP.

According to the ESOP Association, many ESOP's will be terminated if voting passthroughs continue to be mandatory. More important, the association contends that the present law has had a chilling effect in getting new companies to adopt ESOP's and thus even slows the process of ownership participation for their employees.

Perhaps the best way to resolve this issue is to distinguish between theory and practice, between the revolutionary advance in free enterprise thinking which gave birth to the ESOP, and the conservative, necessarily evolutionary processes of change.

For those of us who feel that today's concentrated ownership of industrial capital is morally unjustified and is a flagrant denial of equal economic opportunity, any rational step toward broadened employee ownership, no matter how imperfect in the beginning, is a major step in a new direction.

On that basis, I would reluctantly support, for at least 5 more years, the repeal of mandatory voting passthroughs of closely held companies. I would continue to support the mandatory voting passthroughs in ESOP's with publicly traded stock and would urge the development of special incentives to foster voluntary voting passthrough, full disclosure, and expanded ownership participation among employees in all ESOP companies.

ESOP SMALL BUSINESS ROLLOVER BILL

As I mentioned earlier, my major purpose here today is to seek your support for H.R. 7604, sponsored by Mr. Nowak and Mr. Kostmayer. Its Senate counterpart, S. 2677, was introduced by Senator Stewart and Senator Baucus on May 9, 1980. This bill amends the Internal Revenue Code to provide that, when an owner of a small business—defined as one with $25 million or less in net assets—sells his business to his employees through an ESOP and within 18 months reinvests the proceeds in the stock of another small business, the tax on the proceeds will be deferred until the newly acquired stock is subsequently sold.

While the Treasury projects an annual revenue loss of only $25 million on this bill, it could have a major impact in helping small businesses attract new sources of equity capital and to continue as independent enterprises. At the same time, it should provide a substantial boost to the broadening of capital ownership in the American free enterprise system.

With rising energy costs, rising taxes, rising unemployment, rising labor and material costs, a shrinking pool of higher cost capital credit and declining productivity, the prognosis of our economic future could hardly be more gloomy. We are losing our ability to offer high-quality goods at lower prices than our foreign competitors.

The mainstay of our business world, the independent business, remains frustrated by Washington's seeming inability to cope with our major problems. Instead of providing encouragement and new incentives, Government, in the minds of most businessmen, is the source of the problem, not the cure.

While H.R. 7604 represents only one small part of a new framework for revitalizing our free enterprise economy, it offers an exciting and urgently needed new solution to some problems faced daily by the small business community.

For example, under current law, when a small business is sold or liquidated the owner must pay capital gains taxes. He must pay capital gains taxes also if he sells his stock to an ESOP or directly to his employees in the unlikely event they have cash. However, if he exchanges his stock with the stock of an established firm, the exchange is tax free and taxes are paid only when the new stock is sold. This tax deferral serves as a major inducement for the owners of well-managed businesses to turn over their businesses to major conglomerates.

The net effect of this capital gains tax is to cause the disappearance of vigorous competitors in the economy, the takeover of local businesses by outside forces who have little or no accountability to workers and suppliers in the community, the disruption of well-established management practices and company incentive programs and sometimes the pirating of patents, trade secrets, and cash reserves until the original company is left an empty shell and its employees are consigned to welfare and unemployment lines.

H.R. 7604 provides the businessman who wants to sell to his employees the same tax treatment he can get by swapping stock with a conglomerate, thus keeping his business in friendly hands. By setting up an ESOP, the employees are provided the same access to nonrecourse capital credit that ordinary stockholders get when a corporation borrows directly to acquire its growth capital or existing stock.

Most employees cannot afford enough, after paying personal taxes and meeting rising living costs, to buy stock from a retiring owner.

Here is where the ESOP can help employees as a group to buy major blocks of stock on credit repayable with pretax corporate dollars. Because of its unique ownership-sharing objectives, the ESOP has been recognized as an innovative tool of corporate finance, providing all employees as a group with access to capital credit secured with future pretax profits.

The source of this capital credit can be the owner himself, the local bank, pension plans of unions or other companies, other stockholders, the Small Business Administration, even the corporation itself. Or the business owner could sell his stock to the ESOP in smaller blocks over time, receiving cash from annual employer contributions.

Thus this bill, for relatively minor tax impact—no more of a loss than under a stock swap with a conglomerate—would be good for employees, good for present owners and good for local communities.

In addition this bill would create a major pool of sorely needed new equity capital for other new and growing small business ventures. Within 18 months the owner selling to an ESOP would have cash proceeds to invest as venture capital with other entrepreneurs or in a diversified portfolio of other small firms. His choices would be varied, considering that over 75 percent of all firms on the American Stock Exchange and most firms on regional exchanges have less than $25 million in net assets.

Thus, while the present tax laws favoring tax-free stock swaps with conglomerates add nothing to meet our Nation's capital formation problem, H.R. 7604 represents an immediate source of growth capital to expand our productive sector and put productive workers back to work.

Finally, a good case could be made that conglomerate stock swaps, by fostering concentrated ownership and reducing marketplace competition, help fuel today's inflation. To hold down costs of our goods in works markets, we now realize that productivity must be dramatically improved. As already discussed, that means newer and more efficient technologies and investments. And it means motivating employees to think and act like owners.

Study after study has shown that, when employees can earn a significant ownership share, company productivity is increased and company profits rise dramatically. A University of Michigan survey research center study showed that employee-owned companies were 1.5 times as profitable as conventionally owned firms and that the more stock owned by employees, the higher the profits.

A survey by the Senate Finance Committee on 75 ESOP companies found that in 3 years after adopting their ESOP's, profits increased by 157 percent, sales by 72 percent, employment by 37 percent and sales per employee—productivity—by 25 percent. But, reflecting the tax synergy of the ESOP, taxes paid by these ESOP companies increased by 150 percent.

There is much more that I could add to explain how the ESOP works, its history and its philosophical framework. Much of that is covered in my article "Beyond ESOP: Steps Toward Tax Justice," which appeared in the April and July 1976 issues of the Tax Executive, which I am enclosing for the record.

[The article follows:]

Beyond ESOP: Steps Toward Tax Justice[†]

By NORMAN G. KURLAND[*]

> **"Our tax system is a national disgrace."**
>
> **--President Jimmy Carter, during his 1976 Presidential Campaign**
>
> **"The Congress in a series of laws . . . has made clear its interest in encouraging employee stock ownership plans as a bold and innovative method of strengthening the free enterprise system which will solve the dual problems of securing capital funds for necessary capital growth and of bringing about stock ownership by all corporate employees."**
>
> **--Section 2701, U.S. Tax Reform Act of 1976**
>
> **"To begin to diffuse the ownership of capital and to provide an opportunity for citizens of moderate income to become owners of capital rather than relying solely on their labor as a source of income and security, the Committee recommends the adoption of a national policy to foster the goal of broadened ownership. . . . Whatever the means used, a basic objective should be to distribute newly created capital broadly among the population. Such a policy would redress a major**

[†] This is Part 1 of a two part article. Part 2 is scheduled for publication in the July 1977 issue.

[*] A member of the bar of the District of Columbia and former Washington counsel for Kelso & Company, Inc., Mr. Kurland now heads his own investment banking and consulting group. He is widely recognized as an authority on ESOPs.

> **imbalance in our society and has the potential for strengthening future business growth."**
>
> **—1976 Annual Report of the Joint Economic Committee of the U.S. Congress**

The Carter administration has announced its intention to submit to Congress a package of comprehensive reforms to the U.S. tax system. No one knows exactly what that package will contain and whether it will represent some fundamentally new directions in U.S. tax policy. But if there is to be a new world economic order, as President Carter has promised, no stone should remain unturned in the debate that will shape the tax philosophy of the President. It is in that spirit that this article is written.

The monumental task of reforming the U.S. tax system requires willingness to go back to the beginning, to reexamine fundamental principles and ideals from which this unique nation was born, and to question any assumptions in current economic and tax philosophy that may be inconsistent with those fundamentals. The forthcoming debate will certainly center around issues of *justice*, *equality* and *loopholes*, terms bound to produce confusion and divisions among Americans if their thinking remains shackled along present ideological lines. This article will suggest a philosophical framework that offers new definitions for these vague expressions and an alternate perspective for understanding basic issues of tax reform. It attempts to shed more light on the philosophy behind the creeping movement on Capitol hill to foster a new national goal of broadened capital ownership. And it attempts to explain the broader context surrounding employee stock ownership plans (ESOPs) and how it fits into a more comprehensive national ownership strategy, within which a totally new approach to taxation is a prerequisite. Finally, this article offers new guideline suggestions to unite opposing forces on some of the most controversial issues facing tax reformers. At the very least, the writer hopes to provoke thinking people, persons who recognize their responsibility for making today the decisions that will determine the way of life twenty or thirty years from now, to think again.

MARX AND ENGELS OR KELSO AND ADLER?

Since the goal of equality has a certain universal moral ring to it, as we boldly approach the tax system as an instrument for achieving greater equality for Americans, we should be reminded of de Tocqueville's final warning to us after observing American democracy in action:

> The nations of our time cannot prevent the conditions

> of men from becoming equal, but it depends upon themselves whether the principle of equality is to lead them to servitude or freedom, to knowledge or barbarism, to prosperity or wretchedness.

Let us start with a simple thesis. Political democracy cannot preserve the institutions of a free society unless everyone can participate on an equal basis. An economically free and classless society—another way of describing economic democracy—is therefore both a goal and a means for supporting political democracy. Where opportunities to accumulate wealth are grossly unequal, great inequalities in the distribution of wealth are readily seen as flagrant contradictions to the goal of a free, just and economically classless society. Therefore, attacking the problem of inequality of wealth is a legitimate concern of a democratic government. How to build an economically free and just social order, however, forces us to think about what we mean by economic justice.

A thorough search through the literature of Western civilization for a pathway to a just economic order, will eventually lead the serious scholar to two seminal philosophical works, each diametrically opposed to the other, not in their quest for an economically free and classless society, but rather in the moral and political principles and the institutional framework each considered necessary for achieving economic democracy.

That the first one, written in 1848, has had a profound and growing influence on tax philosophy and tax reforms around the world, is hardly debatable. In the second chapter of The Communist Manifesto, Karl Marx and Friedrich Engels presented a list of ten measures "which appear economically insufficient and untenable, but which in the course of the [communist] movement, outstrip themselves, necessitates further inroads upon the old social order, and are unavoidable as a means of revolutionizing the mode of production." Marx and Engels described these ten measures as "despotic inroads on the rights of property" which the propertyless masses will use to "wrest, by degrees, all capital from the bourgeoisie [and] to centralize all instruments of production in the hands of the State." Besides calling for abolition of property in land, the extension of factories and instruments of production owned by the State, and the centralization of the means of communication and transport in the hands of the State, among other things, the second and third items on the list were:

2. A heavy progressive or graduated income tax.
3. Abolition of all rights of inheritance.

If Marx and Engels have correctly predicted that the ultimate conclusion of their pathway to economic justice is a society where everyone is equally propertyless, equally liable to labor for a single employer, the State, and equally dependent for their subsistence on wealth redistributed by the State ("the dictatorship of the proletariat"), do the roots of America offer a better road to a free and classless economic order?

Directly challenging Marx and Engels, Louis O. Kelso and the eminent American philosopher Mortimer J. Adler reasoned in The Capitalist Manifesto (1958) that, while concentrated capital ownership was manifestly unjust and destructive of a free and democratic order, a higher order of economic justice should be built upon the proposition that *everyone, as a fundamental human right, must become an owner of capital*. Property as an institution was not the fundamental flaw of nineteenth century capitalism, as Marx and Engels asserted. And the redistribution of income is not necessarily just and orderly. Rather, countered Kelso and Adler, an industrial society could achieve a more just and orderly distribution of wealth by preserving the institution of private property and redistributing future ownership opportunities. Thus, as new and more advanced technology is added, more and more and gradually all persons would gain direct property stakes in productive resources. Following the wisdom of America's founding fathers and some of history's greatest political philosophers since Aristotle, Kelso and Adler made a logical and socially compelling case (to which no article as brief as this can do justice) that the institution of property is a prerequisite for preserving a free society and the foundation upon which all other human rights must be grounded.

Since, in the words of Daniel Webster, "power naturally and inevitably follows the ownership of property", a society where all power is supposed to rest in its citizens, must necessarily develop means to keep property broadly diffused.

The world-wide moral appeal of this fundamental right is recognized by Article 17 of the UN's Universal Declaration of Human Rights, which reads: "Everyone has the right to own property, alone as well as in association with others."

Moreover, argued Kelso and Adler, welfare and charity, while justified as humane, short-term expedients for coping with severe cases of economic deprivation, offer no lasting, politically realistic solutions to economically unjust situations. As expedients, however, they can be carried on simultaneously with a comprehensive long-range program for restructuring the future ownership patterns of a society.

The Kelso-Adler version of a just society rests upon three basic principles of justice:

An Input or Principle of Participation. Since everyone has the right to life, everyone must be provided, as a fundamental human right, the right to produce a self-sufficient income. In other words, one can legitimately participate as a producer of marketable goods and services, either as a worker or as an owner of capital instruments, or both. In terms of a high technology society, Kelso and Adler would redefine the term equality of economic opportunity to require government to lift all barriers and take affirmative action to promote more equal access to the future ownership opportunities. Where new capital formation is added through expanded bank credit, for example, this means that everyone should be provided equal access to society's credit system.

An Outtake or Principle of Distribution. Reward should be based, not on one's clout or on charity, but on the value of one's input to production, whether through one's human efforts or through one's ownership of productive capital, or both. If a person wants to consume more, it follows that he must produce more; otherwise he must become dependent on the wealth produced by someone else's labor or someone else's property. However, just as the denial of one's entitlement to the fruits of his hands or mind is a denial of his property rights in his own body, taking away anyone's property income is a direct erosion of his property rights in the means of production.

Under the private property principle of wealth distribution, how would wages and profits be determined? Following Aristotle, Kelso and Adler would allow the free and competitive marketplace to determine what is a just wage, a just price, and a just profit. Neither coercion on the buyer or on the seller of any goods or services would be allowed. In the freely competitive marketplace, the laws of supply and demand, not special privilege or superior clout, control economic values. In this democracy of the marketplace, consumer sovereignty reigns and everyone's vote counts.

The Feedback or Principle of Limitation (Anti-Monopoly). Where a few own too much of the means of production and most of society owns too little property or none at all, justice is automatically denied. No one is born with property in the means of production. In a free society everyone is born with property in their own bodies. The ownership of capital is wholly determined by society's institutions, which in turn are products of society's laws. Hence, no monopoly can exist without the approval or tolerance of government. Since most technological gains are produced by improved tools (i.e., machines, techniques, structures, organizations), an economy is inherently unjust if government permits a monopoly over the ownership of its instruments of production. Such a monopoly is a systematic denial of equal economic opportunity because it denies others the right to produce enough to support themselves by owning the tools that produce wealth. Since tools continue to produce more with less and less human efforts, concentrated capital ownership, if left uncorrected, leads inevitably to redistribution and the eventual breakdown of the other two principles of economic justice. By allowing a few to produce radically more than they and their families can consume, others are forced into conditions of dependency. One man's surplus is another man's poverty.

If Kelso and Adler's version of economic justice is more sound than that of Marx and Engels, then we can well understand why tax reform during the last sixty years has failed so miserably. What becomes almost self-evident is that tax reformers in general have put the cart before the horse. By discouraging new capital formation through discriminatory taxes on property and property incomes and emphasizing redistributive goals of taxation instead of encouraging broadened ownership opportunities, tax reformers have elevated the tax system and government stimulated demand to a position higher than the nation's wealth production system, upon which all tax revenues and everyone's ultimate standard of living depends.

SOUND TAX POLICY FOLLOWS SOUND NATIONAL ECONOMIC POLICY

A sound tax policy cannot be constructed upon confused or unsound political or economic principles. The Kelso-Adler concept of economic justice offers a solid foundation upon which business, labor, and government can forge a new consensus and new common strategy to enable our Nation to cope more realistically with today's industrial world, with our capital and other shortages, and with the challenges we can expect from accelerating technological change.

Sound tax policy is based upon a reassertion that once made America the last best hope of mankind. It would recognize that government does not produce wealth and that every subsidy must originate with those individuals whose productive toil and productive capital actually produce society's marketable goods and services, including those diverted through taxation. It would also recognize that wealth is produced most efficiently within competing privately owned enterprises vying to satisfy private consumer demand, with every buyer voting with his own dollars to reflect his choices among available goods and services.

Government, through its taxing and spending powers, has the power to redistribute wealth, in addition to carrying on its originally conceived and more normal functions of enforcing contracts, protecting property, suppressing violence and otherwise maintaining a just and peaceful society. And to the extent it can create legal tools like the business corporations to meet the needs of society, it can regulate them. On the other hand, when business corporations, voluntary associations, or any other specialized social inventions become socially dysfunctional and create, rather than solve, problems for society, government is the instrument through which we overcome the problem, directly or through a restructuring of our institutions and laws. It is not in the nature of government to leave social vacuums unfilled.

As a result of defects in our economic institutions, wealth patterns in America have become grossly distorted. The gap between the very rich and the very poor continues to widen. Class divisions between propertied and non-propertied Americans produce a neverending political battle. This is in the 1976 Annual Report of the Joint Economic Committee, which found that the richest 1% of Americans own over 50% of all individually owned corporate equity and receive about 46% of all corporate dividends, and that concentrated ownership patterns will only worsen in the years ahead because of traditional methods used by U.S. corporations for financing their new capital formation.

Today, as a result of the maldistribution of ownership and income, we have reached a point where government itself is suffering from an acute case of functional overload. Public redistribution and efforts to control the economy have placed responsibilities on government that are contrary to its very nature. The mere shifting of centralized governmental activities to state and local levels totally ignores this problem. Reorganization of the federal bureaucracy is similarly futile.

The State--civilization's most important social invention--can no longer effectively carry on the highly specialized and limited functions for which it was originally designed. The State, in the view of many, is mankind's only legitimate monopoly, our social contrivance for monopolizing coercion and violence. As such, however, it is a highly dangerous and unnatural tool when it tries to assume powers best left to private individuals and their associations, especially where market disciplines are present to govern economic decision-making.

Next to the State itself, the modern corporation is our most important social tool. It is an excellent vehicle for absorbing technology, harnessing together talent and capital, and marketing on a global basis. Since industrial capital produces an increasing share of society's wealth, a sound and just governmental policy would remove roadblocks to broader participation in corporate equity ownership all households, so that the need for governmental intervention and income redistribution would gradually and systematically be reduced to tolerable levels. The corporation is, after all, a mere creature of the law and to the extent it does not serve the ends of justice, our system of justice is necessarily deficient.

Encouraging growth of the corporation while broadening the base of its future stockholder constituency means that the necessary costs of government can then be shared by a constantly growing base of citizens with private incomes distributed directly in the form of paychecks and dividend checks from our corporate sector as a whole.

From a political standpoint, a corporate stockholder constituency consisting of a more representative base of American households would also automatically make management of our largest and most powerful corporations less vulnerable to self proclaimed consumer advocates. As it becomes more directly people connected, the corporation will become more popular as an instrument of society. Corporate profit would soon lose its social and political attackers as companies provided second incomes to the broadest possible consumer base. Making its future growth opportunities accessible to every citizen would enable the corporation, in my opinion, to make a quantum advance in its own evolutionary development as a major component of a domestic society. (In terms of its presently narrow constituency base and its efficiency as a direct distributor of mass buying power, the mass production corporation is still remarkably primitive, about comparable in historical terms to the democratic form of government over a thousand years ago.)

WHAT IS AN ESOP AND HOW DOES IT HELP ADVANCE THE KELSO-ADLER PRINCIPLES OF ECONOMIC JUSTICE?

Congress has acted five times since late December 1973 to promote the ESOP. What has surfaced thus far is only the tip of the proverbial iceberg. Below that surface lies the revolutionary private property philosophy and comprehensive ownership strategy first articulated by Kelso and Adler. Too scholarly in its tone to inspire a new political movement and too revolutionary in its ideas to gain the support of economists and academics wedded to orthodox ideologies and the economic status quo, this bible of an advanced socio-economic order seldom is associated with the history of ESOP, although both were inspired by the same person, San Francisco lawyer and investment banker Louis O. Kelso.

When this writer first became associated with Kelso in 1965, to most politicians, businessmen, and labor leaders, ESOP sounded like the author of ancient parables and Kelso was a famous winning race horse. By 1972 several dozen ESOPs were established. Since Congress legitimated the ESOP an estimated 200 or more classical ESOPs and perhaps 1,000 or more plans that masquerade as ESOPs have been launched. The mass media and professional journals have begun to take serious notice of the ESOP and since 1974 articles on the ESOP have appeared in Time, Newsweek, Fortune, Business Week, The Wall Street Journal, The American Bar Association Journal, Harvard Business Review, The Tax Executive, Barron's, and even The Village Voice. Many criticisms have surfaced regarding the ESOP, some valid and constructive, some simply nitpicking and totally negative, some based upon fear and ignorance. Few recognized that the ESOP, even in its primitive form, is only a small part, a single instrumentality, of a much bigger picture. The most comprehensive compilation of the pros and cons of ESOP were covered in two days of congressional hearings in late December 1975 before the Joint Economic Committee. Without attempting to address these problems here, let us examine the nature and purpose of this controversial tool.

Here is how the Senate Finance Committee, chaired by the ESOP's most ardent champion on Capitol hill, Senator Russell B. Long, describes the ESOP:

> Employee stock ownership plans make it possible for workers in the private sector of our economy to share in the ownership of corporate capital without redistributing the property or profits from existing assets belonging to existing owners. Since its first application as a financing tool in 1957, [ESOPs] have been implemented by a growing number of successful U.S. corporations. Through the vehicle of a specially designed tax-exempt trust, this method of finance offers corporations certain tax incentives and cost-reductions not available under conventional methods of finance. The [ESOP] also allows workers to accumulate significant holdings of capital in a tax-free manner during their working careers,

> **while being taxed only on second incomes received in the form of dividend checks or on their assets when removed from their trust accounts. (Sen. Report 93-1298, Trade Reform Act of 1974, Nov. 26, 1974, pp. 158-9.)**

From this description it seems clear that the classical ESOP is not a mere stock bonus plan, although its legal basis can be traced to the same provisions of the tax laws which deal with stock bonus plans, profit sharing plans, pension plans, thrift plans and other IRS-qualified employee benefit plans. Like the stock bonus plans and the relatively few profit sharing plans that invest heavily in company stock, it is not basically a retirement vehicle, but is designed to link all employees of a company to the full status of stockholders, up to 100% of the company's equity ownership.

The ESOP is an ownership creating tool, **plus.** Unlike profit-sharing and conventional stock bonus plans, the ESOP, if properly designed, adheres rigidly to protecting the private property rights of other shareholders, as mandated by Kelso-Adler principles of economic justice. It does not share **their** profits with non-owners. It does not dilute **their** ownership rights by simply issuing new stock without a corresponding increase in productive capacity or in disposable cash available to the corporation for corporate investment purposes. It merely makes capital growth and growth profits accessible to new owners. Unlike thrift plans, stock purchase plans and stock option plans, the ESOP is a credit device and requires no cash outlay whatsoever from those to whom new equity opportunities are to be extended. It instead makes the magic of non-recourse corporate financing work for new owners, based on credit designed to be amortized with *expanded* future corporate profits. It should not be adopted by a management unwilling to be accountable to its employees in their newly acquired status as stockholders. And the ESOP should not be adopted for financing growth, unless the expansion capital will pay for itself. Then, as long as a baseline after tax cash flow per share held by present shareholders is maintained in the future, all projected increases in after tax cash flow can legitimately be applied for building ownership of newly issued equity into employees, without violating the property rights of existing shareholders.

Here's how the classical ESOP works for financing corporate growth: Suppose a $1 million company with 10 owners and 100 workers needs to double its plant capacity and, having paid out dividends in the past, finds itself with little or no retained earnings. With solid contracts on hand to justify the expansion program, the company turns to a syndicate of lenders who are willing to lend the necessary million dollars for the second plant, repayable with future **after tax** dollars. Management hears about the ESOP and sets one up to cover all 200 employees (including the new 100 employees to be hired when the second plant becomes operational). The ESOP borrows the $1 million, the company gets its cash by selling $1 million in new shares to the ESOP at the current market value, the company guarantees the ESOP's credit by agreeing to pay out of projected future profits enough cash to the ESOP to service the ESOP's debt. If the stock is not pledged as collateral, it is held in an unallocated account. As installments of the ESOP's debt are paid, blocks of stock, once paid for, are divided up according to payroll and placed in each of 200 individual trust accounts. At the end of the financing period on this single transaction, therefore, the average employee will have gained $5,000 in new equity and the right to future dividend checks to supplement his payroll and retirement checks. The original 10 owners will not have lost any of their original equity or dividend rights from their $1 million investment. Even better, the company, through the unique privileges Congress has extended to ESOP financing, is permitted to service the debt for its expansion capital with pre-tax, rather than post-tax corporate dollars, a tax advantage that increases the company's cash flow by roughly 50¢ on every dollar borrowed by the ESOP. This is so because Congress has specially recognized the ESOP, both as a socially improved technique of corporate finance and as a new form of employee benefit. Up to 15% of covered payroll, the cash for servicing the ESOP's stock acquisition debt is treated as a tax-deductible contribution. Although dividends may currently be used to accelerate repayment of the ESOP's debt, under present tax laws stock dividends are discouraged. In the future, Congress may allow corporations to take tax deductions for dividends paid out, perhaps initially only for ESOP acquired stock. (See proposals below.) Then ESOP financing would be designed to be repayable primarily with projected pretax dividend payouts rather than employee benefit dollars, which under today's accounting procedures create an illusion of reducing corporate net earnings.

The Investment Tax Credit ESOP

In contrast to the classical ESOP, the investment tax ESOP can be justifiably labeled as a giveaway, not from present shareholders but from the federal treasury. Nevertheless, unlike other tax subisdies, this bonus to companies adopting an ESOP contain the seeds of the quiet and creative revolution launched by Kelso and Adler. It points to a new direction for business, labor and government and to a gradual overhaul of the tax system itself, along lines suggested in this paper.

Admittedly, qualification for the 1% ESOP tax credit bonus does not *necessarily* affect the manner in which a company finances its new equipment and other capital needs. Legally, the company, as have most of the major corporations that have adopted investment tax credit ESOPs, may simply adopt a traditional stock bonus plan and channel no more stock than that paid for by the government with the extra tax credit dollars. However, more farsighted management will establish a classical ESOP to receive and distribute tax-credit stock to their employees. By combining the full 11% investment credit with ESOP financing of its new machinery, the company combines the tax and other advantages of both types of ESOP. It gains a whole new form of employee benefit as a bargaining chip when employees seek inflationary increases in wages and fringe benefits.

Tax Philosophy Behind the Classical ESOP

As noted earlier, the classical ESOP involves no give-away from present owners. And, unlike the normal 10% investment tax credit, tax deductible payments to a classical ESOP are wholly distinguishable from tax subsidies and should no more be considered a taxpayer gift than that which permits corporations to deduct wages and salaries from gross earnings. While many tax deductions are hardly distinct from direct government expenditures, and thus can be labeled subsidies, this is not the case for deduction of debt service contributions to an ESOP. Rather, from a standpoint of the philosophy of economic justice upon which the ESOP is based, the double tax penalty on corporate profits is a direct violation of the private property rights of a corporate equity owner. The corporation income tax is therefore inherently an unjust tax under any social system which is based upon the institution of private property. If all corporate net earnings were deductible to the corporation to the extent they were paid out directly to the equity owners as dividends and taxable as personal incomes, the double tax problem would vanish. (See proposal below.) It is in this light that the nature of the ESOP can be properly understood.

Behind the ESOP is a philosophy of taxation and a carefully conceived strategy to remove gradually the tax system's present bias against property and property accumulations, on the one hand, and, at some point, to reduce the government's use of the tax system as an income redistribution mechanism, on the other. The 48% corporate income tax involves pure redistribution. Instead of treating all incomes the same, whether they are derived from capital or labor, the tax on corporate profits dilutes by half the property incomes (and thus the property rights) of present shareholders. Then when that income becomes available to owners in the form of dividends or capital gains, the government takes a second bite out of the remainder. Where the corporation tax is a direct frontal attack on the institution of private property, the ESOP offers a powerful means for counterattacking in a manner that will simultaneously serve other desirable social goals: it can help overcome shortages in private sector capital formation; it fosters more equity financing; it can help foster more private sector jobs in the fabricating and operations of newly added plant and equipment; it can help expand the federal revenue base from expanded private payrolls and dividend rolls; and it can help create a broader base of stockholder constituents to help corporations surmount unreasonable and unwarranted political attacks. In contrast to true tax subsidies, the ESOP is a solution, not an excuse for perpetuating or ignoring structural flaws in our major economic institutions. ○○○

Part 2 of Beyond ESOP: Steps Toward Tax Justice is scheduled to appear in the July 1977 issue of The TAX EXECUTIVE.

Beyond ESOP: Steps Toward Tax Justice--Part 2[†]

By NORMAN G. KURLAND[*]

Beyond ESOP, a strategy for capital formation and broadened citizenship participation in capital seems to be an idea whose time has come.

Under a comprehensive national plan for stimulating and redistributing future growth opportunities directly among Americans who have no capital, three basic ownership diffusing mechanisms would be employed to link capital to individuals: employee stock ownership plans (ESOP), to cover employees of viable enterprises; consumer stock ownership plans (CSOP), to cover all regular customers of regulated public utilities and mass transit systems; and individual stock ownership plans (ISOP), to provide people who do not work for viable corporations in the competitive sector of the economy with the means to gain a diversified holding of newly issued stock reflecting growth of the competitive corporate

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[†] This is the concluding part of this article. Part 1 appeared in the April 1977 issue of The TAX EXECUTIVE.

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REEXAMINATION AB INITIO

The monumental task of reforming the U.S. tax system requires willingness to go back to the beginning, to reexamine fundamental principles and ideals from which this unique nation was born, and to question any assumptions in current economic and tax philosophy that may be inconsistent with those fundamentals. The forthcoming debate will certainly center around issues of *justice*, *equality* and *loopholes*, terms bound to produce confusion and divisions among Americans if their thinking remains shackled along present ideological lines. This two part article suggests a philosophical framework that offers new definitions for these vague expressions and an alternate perspective for understanding basic issues of tax reform. It attempts to shed more light on the philosophy behind the creeping movement on Capitol hill to foster a new national goal of broadened capital ownership. And it attempts to explain the broader context surrounding employee stock ownership plans (ESOPs) and how it fits into a more comprehensive national ownership strategy, within which a totally new approach to taxation is a prerequisite. Finally, this article offers new guideline suggestions to unite opposing forces on some of the most controversial issues facing tax reformers. At the very least, the writer hopes to provoke thinking people, persons who recognize their responsibility for making today the decisions that will determine the way of life twenty or thirty years from now, to think again. - - N.G.K.

sector. Each of these tools is structured to reduce drastically the cost of new capital formation and to overcome present tax and credit barriers to a more equitable sharing of future ownership opportunities.

Employe Stock Ownership Plans (ESOP)

As noted previously, present laws already provide for the establishment of ESOPs, although even existing ESOP law could be improved considerably to make the ESOP more attractive to corporate management, labor unions, existing stockholders, and to the employes themselves. Acceleration of private sector investment rates, virtually everyone would agree, is the best means for overcoming economic scarcity and for absorbing into productive jobs close to ten million people whose talents are now being wasted in unemployment lines and in non-productive and wasteful jobs on public and private payrolls. Hence, the highest priority in channeling new capital financing in both the competitive and non-competitive public utility sectors of the private economy should be placed on the use of ESOPs. It offers new efficiencies and cost savings for capital creation and it offers a meaningful tradeoff for inflationary increases in wage and fringe benefit levels. A share in the capital growth pie and in corporate profits offers a far more significant economic benefit than has ever been demanded through collective bargaining for working Americans. Slicing up among workers the $3 to $5 trillion capital pie that the economy expects to be adding in the decade ahead could average as much as $50,000 each for 100 million workers, assuming (without expecting) that all new capital will be financed through ownership diffusing mechanisms.

In the competitive sector, at least one third to one half of a company's annual capital expansion budget should be reserved for financing through an ESOP covering all its employes. Another portion might be reserved for the ESOPs covering employes of outside suppliers and construction firms that help fabricate that company's new plant and equipment. And the remaining portion of its expansion capital should be financed through the sale of new equity to ISOPs.

Individual Stock Ownership Plans (ISOP)

Within the non-regulated, competitive sector of the economy, all future growth (not replacement capital) of SEC-qualified firms, which is not financed through ESOPs, should be financed through ISOPs, established for individuals at their local banks as a supplement to each American's participation in the Social Security system. For example, a company like IBM would sell new equity shares for one-half of this year's IBM expansion needs. Based upon their present overall wealth accumulations and projected new ownership opportunities each year from all sources, plus some other relevant factors, each adult American would be allocated a quota of credit to buy a diversified block of the IBM and other newly issued qualified equity shares. The ISOP would be IRS-qualified and would permit tax-free accumulations. Low interest bank loans to the ISOP would provide the funds to buy newly issued equity directly from the SEC-qualified corporations. The loans would be non-recourse to the ISOP participant and would be structured to be repaid wholly with projected tax-deductible dividends paid out by each of the corporations selling their new equity on the new ISOP market. Stockmarket speculators and other secondary market sources would not be allowed to sell to ISOPs. Once shares of stock are paid for, the owners would receive the dividends as second incomes.

Consumer Stock Ownership Plans (CSOP)

Corporations in the non-competitive, regulated segment of the U.S. economy (e.g., telephone companies, electric and gas production and distribution utilities, mass transit, cablevision systems) would gain opportunities to fund their expansion through new equity issuances sold to CSOPs and ESOPs, with low-interest credit provided from commercial lenders and repayable with future pre-tax profits. A new mass transit system, for example, might have 25% of its total construction costs funded by an issuance of equity shares through an ESOP covering all those involved in constructing the system, another 25% through an ESOP covering its operating and maintenance employees, and the remaining 50% financed through a CSOP designed to build equity shares into each of its future regular customers. Like the ESOP and ISOP, the CSOP would be a tax-free equity accumulator and an account would be set up for each regular transit rider, tied into his monthly billing account. Rates would be set so that, after taking into account any real estate profits earned by the mass transit system, mass transit riders would cover the full capital costs and operational costs of the system, without government subsidies. But for his patronage, the regular rider would get back a piece of the action, represented by shares released to his CSOP account as the CSOP's debt is repaid with pre-tax dollars paid in the form of tax-deductible dividends on CSOP-held shares. Released shares would be allocated among users according to their relative patronage of the system. Future dividends on CSOP stock would be used to offset each user's monthly bill.

Low-Interest Expanded Bank Credit for Expanding Ownership

Under a national planned ownership strategy, the Federal Reserve system, using its present powers to expand bank credit through the discounting of eligible paper, would reduce bank interest rates to 2% to 3% for banks making loans to IRS-qualified ESOPs, ISOPs, and CSOPs to enable mature, well-managed corporations to sell newly issued equity to their workers and other Americans. All loans would be non-recourse to the individual and would be repayable with projected pre-tax profits. The low-interest rates and the use of pre-tax dollars for servicing capital formation debt would, of course, lower the cost of capital expansion within the private sector at least when compared to the use of after-tax dollars and today's high interest rates. Only when all wasted and nonproductive human talent gained work opportunities in the growing private sector and all other resources became fully employed, would the Federal Reserve clamp down on the supply of low interest credit. Any further expansion would not increase production and would therefore be inflationary. A sound national ownership program would aim at a target of zero rate of inflation and a maximum rate of production.

The Capital Diffusion Insurance Corporation (CDIC)

A Capital Diffusion Insurance Corporation would be established to operate with functions similar to those of the FHA home mortgage insurance agency and the Pension Guarantee Insurance Corporation. Part of the interest payment on loans to ESOPs, CSOPs, and ISOPs, perhaps 0.5% or so, would be used to pay an annual premium to protect the lending institutions against the full losses in the event of loan default, to cover the eventuality that the companies issuing the stock against which the loans were made, would no longer be capable of generating profits. Naturally, the safer the companies whose debt-repayment ability is insured by the CDIC, the lower the premium charges necessary to spread the risk of loan default over the overall economy. Differential risk categories, with adjustable premium rates, could be set up for grouping participating corporations, based upon their maturity, earnings history, the quality of their management, the nature and special risks of their industry, somewhat along the lines of Moody's and Standard & Poor bond ratings.

Similar to the pension insurance now being offered by the PGIC, the CDIC could also offer portfolio insurance for an additional premium for employee accounts within ESOPs, which normally lack the kind of diversification that would be found in ISOPs. It would insure workers against the downside risk, so that, upon retirement, a worker would be guaranteed a high percentage of the initial values for all company stock purchased in his behalf through his ESOP account. Then, even if the company failed, he would not lose all his retirement assets before he had a chance to diversify. Premiums could be kept relatively low if CDIC portfolio insurance for ESOPs was limited to companies that had been in operation on a profitable basis for at least three years. The premium costs to cover the high risk, start up companies would be astronomical, compared to those for mature companies with a solid track record of earnings.

WHERE DO WE GO FOR TAX JUSTICE?

On the Purpose of Taxation. If tax reformers become persuaded that redistributive taxation is morally wrong and contrary to the basic values and objectives of a free and democratic society, that redistribution keeps the rich rich and the average taxpayer a job serf, that redistribution leads to unnecessary shortages and bureaucratic wastes, that it perpetuates mass propertylessness, then it may be possible to make a new beginning in rebuilding today's overly complex, inherently unjust tax system. Until someone offers a more definitive overview of what constitutes tax justice, let us take advantage of the guiding principles and general strategy conceived by Kelso and Adler, at least to analyze some of the central issues all tax reformers must face. Any new beginning must start with the simple question, "Why do we have a tax system?" If we reject Marx and accept Kelso, the answer is also simple: to yield the revenue to pay the costs of a limited government, without damaging the incentives to the maximum production of wealth and the broadest distribution of capital ownership. From this point, a whole new set of conclusions follow:

The bias in the present tax laws against property accumulations and property incomes should be removed. The bias in favor of redistribution, as a practical matter, must be more gradually phased out, as redistribution of income is supplanted with an effective program of redistributing future ownership opportunities. The tax system and federal laws generally should be re-structured to encourage the creation, accumulation and the maintenance of property, its widespread distribution among all households, and the maximum generation of new wealth and improved technology within the free enterprise system. Government should announce a target goal for the economy of a minimum floor of capital self-sufficiency for every household to achieve within the next thirty years. A national ownership plan, including new tax laws, would be launched to reach that goal, similar to the manner in which government assisted Americans in the building of our agricultural base through the Homestead act of 1862. Although the 160 acre ceiling made sense in distributing shares of our necessarily finite land frontier, the amounts that could be accumulated under this industrial homestead program is limited only by our talent, our know-how, our technological potential, and our ability to mobilize all our resources in building a new and more productive industrial frontier during the next several decades. Hence, in today's world, a target floor is more appropriate than a ceiling as the focus of government initiatives under a national ownership program. Where most government initiatives in the last century have tended to centralize economic power, these initiatives would aim at widely diffusing economic power, while keeping it in the hands of individual citizens.

An effective tax system would offer incentives for the enterprise system itself, as the principal source of wealth production, to become a more direct and efficient distributor of mass purchasing power for all consumers in the economy.

As the need for income redistribution and governmental intervention within the private sector lessens to an irreducible minimum, the functions and costs of government should drop progressively, eventually to the tolerable levels projected by the founding fathers. Instead of constricting private initiatives and production, as under today's tax laws, government, under a soundly conceived national ownership strategy would become a major stimulant to production.

Since government, by its nature and highly specialized social functions, is a monopoly, it is not inherently an efficient producer of wealth, as the followers of Marx are beginning to discover. And, with a few rather unfortunate exceptions government in the United States does not engage directly in the production of real wealth. Although some redistribution advocates seem to assume that all wealth is produced by government, taxpayers know otherwise. Since the wealth necessary to cover the costs of government are products of private labor and private capital, taxes should be viewed as charges to consumers for essential services not available through the private sector. Unlike other services, however, the buyer is compelled to buy and the government will remain the sole seller, at least until these same services can be satisfactorily provided through the competitive enterprise system. This seemingly minor change in emphasis could open up some new ideas and new opportunities for creative businessmen.

Direct or Indirect Taxation. Any tax blunts incentives, but a direct income tax on individuals is the least damaging and, at the same time, places before the electorate the cost of government. Sales taxes, consumption taxes, value added taxes, most excise taxes, and other indirect taxes, not only mask the spending patterns of public servants and elected officials from close taxpayer scrutiny and direct accountability. Indirect taxes also add to the costs of goods, thus shifting taxes to the consumer, reducing the competitiveness of U.S. enterprises and also our growth. Taxes on property discourage new construction, improvements, and maintenance. But taxes on corporations are the most counterproductive of all forms of indirect taxes. The corporation income tax damages the corporation, an invention of man that is indispensable to the maximum production of wealth. To the extent return on investment is reduced, growth is stifled and the investment will go elsewhere. But a more serious practical effect of present corporation income tax laws is the incentive they now offer to the financing of industrial growth without the issuance of new equity instruments. The non-deductibility of dividends encourage the use of retained earnings or conventional borrowings for financial growth. Thus, the corporation tax minimizes opportunities for all households to share in the growth opportunities of the economy.

Rates of Taxation. A growing number of tax scholars have argued that the case for progressive or graduated rates of taxation is uneasy at best. If redistribution of income (in contrast to a redistribution of future ownership opportunities) is a form of direct discrimination against property, a progressive income tax is inherently an unjust tax, assuming one accepts the Kelso-Adler, rather than the Marx-Engels, version of economic justice.

But what about the poor? No more effective aid can be provided the poor than allowing them to share in the new job and ownership opportunities within a healthy and growing private economy. The problem of those still too poor to share in the cost of government can be handled through tax exemptions or tax credits, and perhaps even the kind of negative income tax advocated by Nobel prize winner Milton Friedman.

Yet responsible citizenship is best served when everyone pays some direct tax. In an economy productive enough to provide a high standard of living for all households, which should be the long-range goal of economic decision makers, the cost of government would be minimal. Since government benefits should be equally accessible to each member of society, absolute justice would demand an equal per capita charge on all individuals, without regard to their income levels. But this, of course, is impractical at this stage of our economic history.

A more realistic and just tax today would be a flat or proportionate rate imposed on all direct earned and unearned incomes of all taxpayers. It would be administratively more efficient than a progressive or graduated tax. And it would help make government vastly more accountable to the electorate. If tied into a vigorous national growth and expanded ownership strategy, one could easily imagine future candidates for public office actually competing for votes on the basis of who could offer the best government services at the lowest flat rate. Each year's single direct tax rate could be adjusted up or down to provide sufficient revenues to avoid budget deficits.

Under a progressive or graduated tax, on the other hand, political irresponsibility and waste is more easily tolerated. Many voters believe that the heaviest costs are borne by a tiny fraction of high-income individuals or by fat cat corporations, or they fail to appreciate the dangers of printing press money where there are sizeable budget deficits. A flat tax would help raise the levels of economic sophistication of the taxpayers. Another shortcoming of a progressive or graduated tax is that tax evasion and the search for tax loopholes increase as tax rates increase. And when inflation forces workers into higher tax brackets, pressures for additional pay increases add more fuel to the inflationary fires.

Resources tend to be misallocated under a progressive or graduated tax. Economic decisions become increasingly made, not on their economic merit, but on tax considerations. Thus, high tax brackets stifle growth and incentives to innovate and increase production, making all of society the poorer and less competitive.

Earned or Unearned Income. Under the Kelso-Adler theory of economic justice, the earnings from one's property in the means of production are morally indistinguishable from the earnings produced by one's skill or brainpower. Since they are both rewards directly related to production, they should be taxed alike. And discrimination against property discourages investment and reduces society's overall productive capacity.

Karl Marx considered profits as income stolen from labor. Our tax laws that discriminate against property incomes reflect the same bias. But if capital is recognized as a producer of wealth, then capital incomes are legitimately earned by those who share property rights in that capital, the same as those paid for their skills and ingenuity. The most serious problem with laws that discriminate against property incomes is that they hurt the poor more than they do the rich. Access to the full, undiluted stream of earnings from capital is a prerequisite for the financing on credit of broadened ownership opportunities and for more widespread distribution of second incomes among today's non-owning citizens, including civil servants, many professionals, teachers, the military and the unemployable.

The only form of income that can properly be classified as unearned is that which is truly gratuitous and wholly unrelated to the production of marketable goods and services. Such unearned income, which should be directly taxed at the same rate as earned incomes, would include: welfare checks, unemployment checks, social security checks, gifts and bequests, unclaimed valuable findings, gambling gains, and other gains not immediately converted into tax-free individual capital accumulations, as described below.

Individual Capital Accumulations. As discussed previously, building capital self-sufficiency into every American household cannot take place overnight. But once we establish a specific minimal level or floor as a ten or twenty year goal to strive toward, it allows everyone to focus on the importance of property and the need to remove all institutional barriers to the broader distribution of ownership opportunities as expeditiously as possible. The floor of capital accumulations per household should represent the industrial equivalent of the 160 acres of frontier land that the federal government made available to its propertyless citizens under the Homestead act of 1862. Thus, the tax laws should be reconstructed to encourage the tax-free accumulation of an industrial homestead for all Americans over their working careers, consisting of a growing number of equity shares in the economy's expanding industrial frontier. Each individual would set up a tax-qualified ISOP at his local bank to serve as his tax-free accumulator of capital. Shares acquired through ESOPs and CSOPs could be rolled over into one's ISOP account tax-free, as well as income-producing property acquired through tax-free gifts and bequests. Each individual's total acquisitions would continue to accumulate in a tax-free manner until the federally established capital sufficiency floor was reached. Thereafter, future accumulations would be subject to a reasonable wealth tax, designed to discourage grossly excessive, monopolistic accumulations of capital in the future. Fairness in the distribution of future ownership opportunities would mainly be controlled through the traditional IRS tax-qualification controls over discriminatory allocations and through the Federal Reserve Board's control over bank credit allocated to foster growth of the economy through ESOPs, CSOPs and ISOPs.

Under H.R. 462, the proposed Accelerated Capital Formation Act introduced by Ways and Means Committee member Bill Frenzel, this tax-free floor was set at $500,000. Whatever the target amount, it should be set at a level that both fosters initiative and a desire for income independence for its owner, and it could be adjusted to rise with a person's age and capacity to work. To encourage the continued accumulation and retention of income-producing investments, and to discourage squandering, all tax-qualified accumulation trusts would be required to pay out all property incomes on a regular basis as second incomes to the owners, subject to direct personal income taxes.

The rationale behind permitting tax-free accumulations below excessively large wealth concentrations follows the principle that new capital formation and widespread capital accumulations should be encouraged, both for promoting economic democracy and for raising the standard of living for all citizens. Taxes on property slows down the capital creation and accumulation process. On the other hand, a direct tax on the incomes from already accumulated capital assets is simpler to understand, less harmful to investment and the care of property, and easier for tax authorities to administer.

Offsetting Revenue Losses from Reduced Corporate Tax Revenues and Reduced Personal Income Taxes Channeled Into Homestead Accumulations. Presently the federal corporate income tax accounts only for roughly 14% of total federal revenues. It would shrink in relative size only gradually under even the most optimistic rate of implementing a national ownership strategy . The question is whether the benefits to be derived, from the standpoint of American business, labor, the voting public, and even the Treasury itself, is a worthy trade off for this shrinkage of corporate tax revenues. To weigh the trade off, one must focus on the big picture. The overall dynamics that should be expected in the proposed comprehensive national ownership strategy are two-fold: (1) to increase private production, private taxable job incomes, and private taxable property incomes; and (2) to reduce federal budgets for unemployment, welfare. Hence, the overall tax burden, as now wasted manpower and other resources are absorbed within a faster growing private sector, should gradually be reduced. To argue that the trade off is not worth it, considering today's high unemployment rates and continuing high rates of inflation, would seem preposterous.

Government Debt and Government Deficits. Since tax policy affects the size of the government's debt and government deficits in general, a few comments on the wisdom of debt and deficit spending policies are in order.

Under the influence of Keynesian economic concepts, the objective of many tax decisions in the past forty years is to cure inflation and unemployment. Keynes assumed the continuance of historic patterns of extreme maldistribution of capital ownership, and sought merely to fine tune that malstructured economy through the bureaucratic manipulation of government tax, spending, interest, and money-creation machinery. Structural reforms to our corporate ownership patterns were not part of Keynes' approach to the problems of unemployment and inflation.

In the Kelso-Adler strategy, however, the structural void left by Keynes is met head-on. Kelso and Adler would attack inflation and unemployment at the roots. The main thrust of their approach is to super stimulate expanded rates of private sector capital investment, financed so as to broaden the base of equity owners in society.

The credit financing of corporate expansion must meet rigid standards of feasibility and must be repaid as a self-liquidating investment. New dollars flow directly into new productive capacity. In sharp contrast, government debt seldom, if ever, finances any production increases. Rather, it goes into non-productive spending, war, and even into wastes of human talent and natural resources. Government debt is therefore inherently inflationary. Even worse, when government spending is not matched with current tax revenues, the inflationary impact worsens. Funds must either be borrowed (thus diverting those same funds from productive investment in the private sector) or simply issued as printing press money.

From a standpoint of economic justice, government defiicits make no sense at all. They cause inflation and are therefore a pernicious form of hidden tax on the public, most painful to the poorest members of society. A just tax system would work toward the elimination of future inflationary budget deficits and to curb further increases in the already bloated government debt. Better yet, a concerted effort should be made to begin to repay this debt.

Today the Federal debt already exceeds one half trillion dollars or 35.5% of the GNP. Annual interest charges on this debt -- one of the highest expenses in the entire budget -- amounted to $34.6 billion in 1976 and are rising. President Carter envisions a $68 billion deficit for the current fiscal year (widened from President Ford's $57.2 billion) and projects at least a $57.7 billion budget deficit for fiscal 1978.

Inheritance Policy. Under a national ownership strategy, inheritance policy should be restructured to discourage excessive concentrations of wealth and, in order to promote individual initiative and capital self-sufficiency, to encourage the broadest possible distribution of income-producing assets. Gift and estate taxes therefore should not be imposed on the donor or his estate, but rather on the size of the recipient's total accumulations after receiving the gift or bequest. If the value of the recipient's homestead accumulations remain below the floor mentioned above, no tax would be imposed on the newly acquired assets. Above that floor, a reasonable wealth tax would be paid.

Wealth Tax. Above the targeted homestead accumulation floor, a wealth tax would be imposed on each new owner to discourage future excess concentrations of wealth and economic power. It would replace the existing estate and gift tax systems. The wealth tax could be avoided by distributing excess accumulations to others, including family members, friends, and employees, as long as their accumulations remain below the floor.

Integration of Personal and Corporate Income Taxes. The double tax penalty now imposed on corporate profits is becoming widely accepted as an unjust form of tax discrimination that should be eliminated. Some reformers are proposing to mitigate this problem through a highly complicated and arbitrary compromise that not only avoids the problem but worsens it. Instead of eliminating the double tax directly at the corporate level, they would permit a partial deduction for dividend payouts to the corporation and a redistribution oriented partial tax credit for shareholders. Hence, it neither restores private property in corporate equity nor does it promote expanded distribution of equity issuances. It merely makes the top 1% who own the majority of directly-owned outstanding corporate shares even richer.

The Kelso-Adler theory of tax justice would attack this problem directly with elegant simplicity. It would recognize that property and profits are inseparable and therefore all corporate net earnings, whether distributed or retained by the corporation, are earned by its owners and therefore should be taxable at the personal level, on the same basis as any other direct income. Under this alternative, the corporation would be treated for tax purposes like a partnership, with its business expenses attributed at the enterprise level and all capital incomes attributed individually according to each owner's proprietary stake in the business. To encourage more equity financing of corporate growth, higher dividend payouts must be encouraged and alternative low-cost sources for financing must be made available to expanding and viable new enterprises.

Dividend Deductions at the Corporate Level. Corporations should be allowed a dollar-for-dollar tax deduction for any dividends they distribute either (1) directly to their shareholders (including beneficial owners, such as employees under tax-qualified ESOPs, profit sharing plans, pension plans, etc.) to the extent such earnings become currently taxable at the individual level or (2) to repay stock acquisition indebtedness on any new equity issuances through tax-qualified financing mechanisms that further the goals of a national planned ownership program.

Capital Gains Taxation. How to tax capital gains is a continuing source of much of the complexity and confusion that now plague our tax laws. How would a property oriented theory of tax justice handle this problem?

First, it would restructure the tax laws to encourage investment and discourage speculation. It would add disincentives to gambling in high-risk securities and the commodities market, at least for non-wealthy individuals. Tax laws would be designed to facilitate the acquisition, accumulation and retention by today's capital-deficient Americans of long term investments, held mainly for their potential of yielding high, steady, and relatively secure second incomes to supplement their paychecks and retirement checks in the future.

To the extent capital gains income results from short term purchases and sales of commodities and securities, as under present law, it should be treated like any other kind of direct personal income.

Capital gains from long term holdings deserve different treatment, however, under a national strategy to broaden the base of capital ownership. As recommended above, to the extent that investments are accumulated within a tax-qualified vehicle, the gains should be permitted to increase tax-free, until the individual affected reaches a targeted floor of capital self-sufficiency. Above that level, gains would be subject to a reasonable wealth tax.

If all of the proposals recommended in this article were adopted, the capital gains problem would gradually disappear. Much of the appreciation in the values of corporate common stock can be traced to the retention by management of earnings for meeting their capital requirements. As dividend payouts increase and new sources of equity financing become readily available, the value of individual shares would tend to stabilize over time and be based on current and projected dividend yields per share. Hence, long term capital gains would be less a source of future government revenues.

To some extent, long term capital gains result, not from the increased productive value of the underlying assets, but from a gradual debasement of the American currency. Only inflation inducing government economic policies can be blamed for these increases in profits and capital values. Hence, except where prices increase from natural shortages, government should assume total responsibility for inflationary increases in the value of investments. Therefore capital gains taxation should always be inflation indexed to see if any gains in value actually exist.

State and Local Tax Systems. Today, a heavy portion of local revenues come from the taxation of property, thus discouraging investment and improvement of industry and residential property in their areas. Sales taxes also increase price levels, encourage tax evasion by local merchants, discourage trade, and generally can cause one area to become less attractive than another. Since high production, high incomes, and a higher quality of life rests on the quality of the structures, industrial equipment and facilities, and technology available to the residents of an area, it should be obvious that taxes on local property are counter productive and should be gradually supplanted with a universal system of state and local taxation based upon the direct incomes of its residents from whatever sources. Thus, federal tax policy should create additional incentives for state and local taxing authorities to gradually shift to direct flat rate income taxes at the individual level, for the same reasons outlined above. To simplify tax collections, the state and local rates could be set at a percentage of the federal tax imposed on residents of the area. Another advantage of this approach is that all areas of the country would become tax-neutral for investment purposes, thus increasing the nation's overall efficiency in the allocation of our manpower and other resources.

Tax Simplification. Although the wealth tax discussed above is new and may be initially resisted by those fearing disclosure of their property holdings (for understandable reasons given the redistributive, anti-property bias of current tax philosophy), a wealth tax would be much simpler to administer than the present estate tax and gift tax, and much less confiscatory. Through assets accumulated within ESOPs, CSOPs and ISOPs, within one generation, the nation would gain a useful profile of total property accumulations and its wealth distribution patterns. It would also be a way of meeting the recommendation of the Joint Economic Committee in its 1976 Annual Report calling for:

> [A] quadrennial report on the ownership of wealth in this country which would assist in evaluating how successfully the base of wealth was being broadened over time. (p. 100)

In the final analysis, an annual wealth tax return is no more onerous or an invasion of privacy than an annual income tax return. And since under a national ownership strategy at least 95% of American households would be classified as capital deficient and therefore beneficiaries of a planned ownership program, one could reasonably anticipate little taxpayer resistance to a wealth tax, if it was carefully designed and communicated to the American people. Even the wealthiest families would gain by a reduction of the confiscatory bias of the present tax system and the promotion of private property industrial homesteads based, not on a redistribution of present wealth, but a redistribution of future growth opportunities.

Although corporate income tax returns would still be important for disclosure purposes and for corporations unwilling to pay out their earnings fully to their stockholders, most of the tax revenues would flow from the expanded personal tax base. The personal income tax return and the tax system itself would, as result, be enormously simplified and easier to understand.

A CHALLENGE AND A TOOL

The main purpose of this article is not to offer definitive answers but to suggest some new questions that tax professionals might pose in evaluating tax reform proposals in the future. It is not intended to leave the reader feeling comfortable, because the history of tax reform leaves little room for optimism about the future of the privately owned corporation and the free enterprise system in general. But, it might aid the socially minded business statesman to gain some deeper philosophical insights into the history and trends of tax reform over the last century. Whether Karl Marx' tax strategy will succeed in finally destroying the privately owned corporation and converting it into one owned and controlled by a dictatorship of the proletariat, remains an open question.

Some in the business world seem unconcerned as to who signs their salary check. They seem to have thrown in the towel to Marx. Others seem prepared to take a new stand against further erosion of our private property system. It is the latter to whom this discussion is primarily addressed.

The author rejects the piecemeal and narrowly partisan approach to tax reform. This is a call for a new tax philosophy that will transcend the interests of special power blocs and interest groups. The tax system affects each of us, and will certainly affect the kind of society we will bequeath to future generations of Americans. Armed with a set of principles that are totally consistent with the revolutionary philosophy that fathered our nation, each of us can better judge tax reform proposals as they are presented to the American people.

When proposals are delivered to Congress, we need to judge whether those proposals will move us toward tax justice or toward further tax injustice, whether they support property or are further despotic inroads on the rights to property, whether Karl Marx has won another victory or whether we have turned in a genuinely new direction.

Senator Russell Long, when he urged his Senate colleagues to consider converting the failing northeast rail system into a 100% employee owned private corporation, said:

> [T]here are but three political-economic roads from which we can choose. . . .
>
> We could take the first course and further exacerbate the already intensely concentrated ownership of productive capital in the American economy.
>
> Or we could join the rest of the world by taking the second path, that of nationalization.
>
> Or we can take the third road, establishing policies to diffuse capital ownership broadly, so that many individuals, particularly productive workers, can participate as owners of industrial capital.
>
> [T]he choice is ours. There is no way to avoid this decision. Non-action is a political decision in favor of continued, and indeed increased, concentrated ownership of productive capital.

OOO

Mr. Kurland. Suffice it to say at this point that the ESOP addresses a fundamental issue of justice that has been too long ignored by the economic theorists who guide our decisionmakers—namely, the issue of who should own and control the productive enterprises of our future economy—the top 1 percent of Americans who today own 50 percent of all directly owned corporate stock? Large institutional investors and pension funds? New forms of collectives? Government?

Among all of the alternatives, the ESOP seems to offer the best instrument yet devised for building future individual ownership stakes from the ground up so that all productive Americans will have more direct and equitable access to future ownership opportunities. It is difficult to imagine how the American free enterprise system can survive without it.

I know of no less costly way for this committee to demonstrate its support of the goal of broadened ownership and help stimulate small business development than by acting now, before the November elections, to adopt H.R. 7604.

Mr. Stark. Thank you, Mr. Kurland.

I have to again repeat, as I did to Mr. Sanders, that H.R. 7604 is not the subject of these hearings. Your testimony on H.R. 7604 is appreciated.

I have a hunch that I would share your feelings about control and voting passthrough. My own feeling is that it is pretty much a philosophic argument and that you probably will find that most politicians, like myself, if you have to come down on one side or the other, you will come down on the side of democracy and say you can't take voting rights away because you are making second-class stockholders out of the guys we are trying to help in the beginning. We are trying to talk out of two sides of our mouths.

On the other hand, I appreciate very much your feeling about management's fear or reluctance to release control. I have discussed that with some of my own associates in my own private business interests and I think it does exist, but I guess the political answer is going to be, I think, to support the—small "d"—democratic principles, and I think you are quite right. In a lot of cases that is merely paying lip service in our planning or corporations today and it has changed from what it was.

I think that I would be less than direct if I didn't find—and I suspect I am as selfish as the next person and not quite as creative as Mr. Kelso and some of his adherents—that the ESOP's have tended, at least in my limited experience in the Bay Area, to be pursued more often as corporation finance vehicles. I say that not as a pejorative criticism because to some extent the employees benefit. But when I tend to look at some of the creative financing deals that have been put together, bankers who tend to look at a lien on wages as the most secure lien they can get in a business that may not have real estate or other good collateral, it is an interesting concept. That may be attacked in the courts, but I begin to suspect that someone is going to spot that 20-year lien ahead of all other creditors, which is how you convince the bank they ought to give you a mortgage on stock, is an interesting concept. But the bankers who promote the loans in the ESOP's have gotten quite adroit on this.

I am not sure it is wrong. The bottom line is that some employes participate perhaps to a greater extent in profit than profit sharing.

I find not a greater deal of difference between profit sharing where the principal thing is company stock. You have a great supporter in the other body in Chairman Long, and I know Chairman Ullman feels that the ESOP concept is good.

But I would only admonish you that I think there is a goose there that is laying eggs at least streaked with gold, and I would probably admonish you not to go too fast because you don't have any real opponents.

There have been no flagrant tax schemes, at least that I have heard of, dreamed up. There are some financing deals that I have to say just in an assessment that I think the motivation of the creator of the ESOP has been to get some good financing for a small enterprise. I don't think that is wrong.

I think if that prevails, someone is going to see through that.

Mr. KURLAND. You are hitting on something that is very fundamental because I happen to have worked with Mr. Kelso for many years. I was his Washington counsel for a number of years.

I think there are good ESOP's and bad ESOP's. I personally think that many of them could stand enormous improvement, and particularly they can stand improvement in getting the ordinary rank-and-file worker to understand what is going on.

Mr. STARK. Have you seen this? I think it is a guy in New York who publishes a book on how you can sell part of your company to an ESOP and never pay any taxes.

Mr. KURLAND. I saw that, and I think I know what you are referring to. The article is really going to prove disastrous to anyone who follows this man's advice.

Mr. STARK. But I think that kind of thing, where you say here is a way to get full price for your business and still own it and have no intereference from the workers, and pay no taxes, you have to know that for everybody with a closely held business it is going to look like a fine thing. But the point is, if it becomes perceived that what I really believe Mr. Kelso—and I know him and we have argued about it—he used to think it would end the Vietnam war, and I thought that was ascribing too much to the social benefits of ESOP. But he is a genuinely motivated person.

Mr. KURLAND. Even though we are not professionally associated, I believe Mr. Kelso has produced one of the great ideas of the century. People don't understand just how revolutionary the concept is. It goe far beyond the ESOP concept.

Mr. STARK. If it is purely a finance giving, you are going to los the whole ball game. That is a gratuitous bit of advice.

Mr. KURLAND. I agree with you.

Mr. STARK. That is why I almost say, let the voting rights stay.

Mr. KURLAND. I understand, because, as I say, I favor philosophicall the passthrough of voting rights. But when the mandatory votin rights passed, I was upset.

Mr. STARK. I might be able to buy something like a rule, which dea with the idea that voting rights could not be restricted for more tha 5 years. I think in the State of California we have now limited votin trusts to 5 years, and then the shareholders have to vote again. I think that came out of voting trusts. I think there was an Allied Properties as one of the classic ones. There was one created away back, where 3 percent of the stock controlled the whole corporation. It was something like that.

There could be a case made that to lose control early in the game could harm the business or its orderly takeover by puting new management in. If we had a retiring owner who had not collected all of the stock, you might say you could restrict voting rights for not to exceed 5 years, so at least you could make the case that eventually the worker-owners have corporate democracy working for them.

I think you would have a better shot and preserve the integrity of what you are trying to do, of your ESOP principle.

Mr. KURLAND. Well, the fortunate thing is that the IRS and the Labor Department are going to police the ESOP as closely or more closely than anything else that they have policed. They have general skepticism toward the ESOP and they are going to be looking closely at it. So I think ESOP abuses by a business will be kept to a minimum.

The other thing that I can mention that is extremely important and you mentioned it, is that this will be viewed as a financing tool. Well, frankly, some call the ESOP a tax gimmick, but other than the kind of tax proposal that H.R. 7604 envisions, and also in my article there are a number of other tax proposals, I think the ESOP can live within the present tax system and do very well. I don't think there is a need for any other major changes for the ESOP.

As you know, Mr. Kelso goes beyond employee ownership but your point about the use of an ESOP as a financing technique cannot be ignored. It is crucial.

The key to ownership is access to capital credit. If I design my Nation's capital credit machinery so that only a small handful of people have access to capital credit, and the rest have access to consumer credit, I can set up a nation of industrial feudalism.

Frankly, I think 100 years from now historians will look back to America today and they will say, "It was a space age form of feudalism. You had a few people who owned and controlled industrial capital and most of the people were wage serfs."

So, in effect, we have moved away from our roots, from a Nation of many owners to a nation where very few people own. I think upon analysis you are going to find that the key to who owns and the key to who will own in the future is who has access to capital credit. The only tool in existence that links up capital credit, nonrecourse capital credit to the people who don't own today, is the ESOP. That is what makes the ESOP such a fantastic tool. Its potential has not come close to being realized. If we need $3 trillion to $5 trillion in new energy capital and other technologies for modernizing industry so that our economy can grow and become more competitive, the question remains, who is going to have access to those frontiers of new productive capital?

The ESOP, if it is properly promoted and if there are enough incentives so that people will begin adopting it, we can see that the rank-and-file American will be able to share the ownership and power of industrial capital that today is enjoyed by a handful.

We are either going that way or in 1984, George Orwell may be right. That is what Kelso has been saying and I have been saying for many years, and I think it is time for Congress to take a good look at this tool.

Otherwise, the working people are going to remain, in a pejorative sense wage serfs. We have to go beyond wage serfdom. We have to go to the point where every American will have access to capital credit and will be able to own and share in the power of industrial capital. Otherwise productive Americans are either going to remain beholden to the boss or beholden to the political leader or beholden to somebody who is going to dominate their lives.

I don't think that is what America was intended to be. Kelso's idea and the ESOP represents a tool that I am hoping Congress will tak a little bit more time examining it and then promoting it. That is why H.R. 7606 is useful. It attempts to add more flexibility to ESOP law It is an unfortunate provision that it is going to cause some controversy, that is, in connection with the deletion of the voting passthrough

In a sense, I regret this controversy, but more important than th voting passthrough is making sure that more people become owners I concede the voting passthrough as a trivial issue in the short run The long run issue, and the thing that people ought to focus on again is how do we get more people to become owners. How do we bring the power of the economy right down to the grassroots level.

I think neither party, frankly, is doing very much on the broadened ownership issue. There are a handful of people in Congress wh understand what we are talking about and who are doing something t promote broadened ownership, but I find it regretable that the Join Economic Committee in 1976 could say "broadened ownership i a new national goal," and frankly I still don't see that kind of priorit being given to this goal by either party.

So I come here today and you have given us plenty of time, an you are a very busy person, and I appreciate that.

Mr. STARK. You both have been patient and I can blame it on th Republicans for forcing quorum calls and votes today. I think the are trying to stall a rule over there which has nothing to do with yo or me today, but unfortunately I have to run and answer what I a afraid is another trivial rollcall.

Thank you for being here, Mr. Kurland, and Mr. Sanders, and appreciate getting copies of your article which will appear in th record, and we appreciate your testimony today.

[Whereupon, at 5:25 p.m., the hearing was adjourned.]

APPENDIX

The text, staff summary and description, and any written comments received on each bill under consideration follow. The bills are listed in numerical order.

H.R. 4175

(Identical to H.R. 5902 and H.R. 5964)

A BILL To amend the Internal Revenue Code of 1954 to allow a deduction for contributions for the construction or maintenance of buildings housing fraternal organizations

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) section 170(c)(4) of the Internal Revenue Code of 1954 (relating to charitable contributions) is amended by striking out "or for the prevention of cruelty to children or animals" and inserting in lieu thereof "for the prevention of cruelty to children or animals, or, in the case of a contribution or gift to an organization described in section 501(c)(10), for the construction or maintenance of a building the principal purpose of which is to house such organization".

(b) Section 2055(a)(3) of the Internal Revenue Code of 1954 (relating to estate tax charitable contribution deductions) is amended by striking out "or for the prevention of cruelty to children or animals" and inserting in lieu thereof "for the prevention of cruelty to children or animals, or, in the case of a contribution or gift to an organization described in section 501(c)(10) for the construction or maintenance of a building the principal purpose of which is to house such organization".

(c) Section 2522(a)(3) of the Internal Revenue Code of 1954 (relating to gift tax charitable contribution deductions) is amended by striking out "art and the prevention of cruelty to children or animals" and inserting in lieu thereof "art, the prevention of cruelty to children or animals, and, in the case of a contribution or gift to an organization described in section 501(c)(10), the construction or maintenance of a building the principal purpose of which is to house such organization".

(d) The amendments made by this Act shall be effective with respect to gifts or contributions made after the date of enactment of this Act.

SUMMARY

Present law

Under present law, a deduction is allowed for Federal income tax purposes (with certain exceptions not relevant here) or contributions to certain specified types of organizations. In the case of contributions to a domestic fraternal society, order, or association, operating under the lodge system, a charitable income tax deduction is allowed only if the contribution or gift is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals. In the case of the Federal estate and gift taxes, a transfer or gift to a fraternal society, order or association operating under the lodge system is deductible only if (1) the transfer or gift is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, (2) the fraternal society, order, or association would not be disqualified for tax exemption under section 501(c)(3) by reason of attempting to influence legislation, and (3) the fraternal society, order, or association does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office.

In addition, certain types of organizations are exempt from Federal incon
tax (other than unrelated business income tax). One of the types of organiz
tions that is exempt from income tax is a domestic fraternal society, order,
association, operating under the lodge system if its net earnings are devot
exclusively to religious, charitable, scientific, literary, educational, and *fratern*
purposes and it does not provide for the payment of life, sick, accident, or oth
benefits (Code sec. 501(c)(10). Thus, while the net earnings of an exem
fraternal society can be used for religious, charitable, scientific, literary, edu
tional or fraternal purposes, a deduction is not allowable for a contribution
such a society if the contribution may be used for *fraternal* purposes. The Inter
Revenue Service has ruled that contributions to an organization or fund for t
purpose of acquiring, erecting, or maintaining a building to be used by a frater
organization in carrying on its activities are not deductible even though so
of its activities may be of a charitable nature. Rev. Rul. 56–329, 1956–2 C.B. 1

Issue

The issue is whether a deduction should be allowed for Federal income, g
and estate tax purposes for the contribution or gift to a domestic fraternal soci
order, or association, operating under the lodge system, for the construction
maintenance of a building which is principally used to house the organizati

Explanation of the bill

The bill would allow a deduction for Federal income, gift, and estate tax p
poses for a contribution or gift to an organization described in section 501(c) (
for the construction or maintenance of a building the principal purpose of wh
is to house the organization.

Effective date

The provisions of the bill would be effective for gifts or contributions m
after the date of enactment.

Revenue effect

It is estimated that this bill will reduce budget receipts by $5 to $10 mil
annually.

STATEMENT OF HON. JAMES H. QUILLEN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TENNESSEE

I am grateful for this opportunity to testify on H.R. 5964 which I introd
on November 27, 1979. This legislation would amend the Internal Revenue Co
allow a deduction for contributions for the construction or maintenan
buildings housing fraternal organizations.

As the IRS Code now stands, sections 170, 2055, and 2522 allow a dedu
for income, estate and gift tax purposes for contributions or gifs to a dom
fraternal organization operating under the lodge system, only if the contrib
is used exclusively for charitable purposes. Since the buildings housing
fraternal organizations are used for both charitable and fraternal pur
moneys given for the construction, improvement or maintenance of such
ings do not qualify for a tax deduction. Under my bill a deduction wou
allowed for contributions or gifts to a tax-exempt domestic fraternal orga
tion for the construction or maintenance of a building, the principal purp
which is to house the organization.

I think it's important to keep in mind in considering this legislation tha
Congress has already provided a separate, exempt category for those fra
organizations which are exclusively religious, charitable or educational
ture, and which do not provide insurance for their members. My bill
only cover those fraternal organizations which already enjoy tax exempt
under section 501(c)(10) of the Internal Revenue Code, and in no way
extend its benefits to additional organizations. So we would not in this l
tion be extending tax exempt status to a new category of organizations.
those which are already recognized by the IRS as being exclusively rel
charitable or educational could avail themselves of the benefits of my

What my bill does do is expand the category of tax exempt activities
ready tax exempt fraternal organizations to the construction or maintena
buildings housing those organizations. In my opinion, contributions an
to fraternal organizations to build and maintain such buildings is inte
their charitable activities which are now tax exempt. As Mr. Henry C. C
commander of the Masons testified before your Committee:

This legislation would help us carry on your charitable activities because if our membership declines then so correspondingly do our charitable contributions. Our capacity depends on our membership * * *. If you do not maintain the lodge facilities you kill the goose that laid the golden egg because the members supply the funds for the philanthropic purposes * * *. An acute situation exists with regard to need for these renovations.

I think the Masons are an excellent example of the kind of charitable activities which are carried out by these fraternal organizations. As testimony before your committee attests, the Masonic organizations in America contribute more than $1 million every day toward charity. All of the Masonic Temples are engaged in charitable activities such as their program to help children afflicted with aphasia—a total or partial loss of the ability to use or understand words caused by brain disease or injury. The Masons have facilities for this program in some 13 States, including my own State of Tennessee.

You have also received testimony from the Shriners who are engaged in what has been termed "the world's greatest philanthropy"—the Shriners' hospitals for crippled and burned children. The present operating expense for the 21 Shriner hospitals for crippled children is approximately $50 million. Over the years these hospitals have cured or materially helped more than 200,000 children.

Among the other organizations which would benefit from this bill are the Knights of Columbus, the Oddfellows, Elks, Sons of Italy, and the Knights of Pythias.

Mr. Chairman, I know that this Committee is deeply concerned with maintaining a strong and vital independent or voluntary sector in this country, for it is that impulse of Americans which has helped to make this country the great Nation it is today. Even back in the early 1800's, the French visitor to our shores, Alexis de Tocqueville, was greatly impressed with our multitude of voluntary associations which he considered to be the key to our highly successful social system. In his chronicle of his visit, Democracy in America, Tocqueville observed that Americans of all ages, conditions and dispositions are constantly forming associations. In his words:

The Americans make associations to give entertainments, to found seminaries, to build inns, to construct churches, to diffuse books, to send missionaries to the antipodes; in this manner they found hospitals, prisons and schools. If it is proposed to inculate some truth or to foster some feeling by the encouragement of a great example, they form a society.

As so much of Tocqueville's observations are seen today as having been prophetically accurate, his insights on our voluntary associations are especially so. To quote from his work:

It is easy to foresee that time is drawing near when man will be less and less able to produce by himself alone, the commonest necessaries of life. The task of the governing power will therefore perpetually increase, and its very efforts will extend it every day. The more it stands in the place of associations, the more will individuals, losing the notion of combining together, require its assistance: these are causes and effects that unceasingly create each other.

And he went on to write:

In democratic countries the governing power alone is naturally in a condition to act in this manner, but it is easy to see that its action is always inadequate, and often dangerous. * * * Governments, therefore, should not be the only active powers; associations ought, in democratic nations, to stand in lieu of those powerful private individuals whom the equality of conditions has swept away.

Mr. Chairman, because I fear that we are rapidly reaching that point at which our voluntary associations are losing their force and being undermined, and the government is increasingly stepping in to fill that void, I have introduced this bill to help revitalize those fraternal organizations which are making a great contribution to our society through their charitable endeavors. If we turn our back on them now, in their hour of need, they may not be there tomorrow when we need them. The alternative, as Tocqueville pointed out, is more government action which has proved to be an inadequate and even dangerous substitute for individual and collective private efforts to solve our problems. We must maintain a strong independent or voluntary sector if our society is to thrive and our citizens are to find meaning and value in their daily lives. The organizations which would be assisted by this bill are daily providing that meaning and value to their members and making a vital contribution to solving our nation's problems in the process.

I strongly urge the Committee to act favorably on my bill to help insure that these fraternal organizations can continue to make that contribution to our society.

H.R. 4498

A BILL To change certain requirements applicable to purchasers of timber from natio
forests, and for other purposes

*Be it enacted by the Senate and House of Representatives of the United Sta
of America in Congress assembled,*

TITLE I—REQUIREMENTS APPLICABLE TO PURCHASERS OF NATIONAL FOREST TIMBER

SEC. 101. The Act entitled "An Act authorizing the Secretary of Agricultu
to enlarge tree-planting operations on national forests, and for other purpose
approved June 9, 1930 (16 U.S.C. 576 et seq.), is amended by adding at
end thereof the following new section:

"SEC. 4. (a) In lieu of the deposits of money by the purchaser to cover
costs of the reforestation and other forest improvement work specified in s
tion 3 of this Act, the Secretary of Agriculture may require the purchaser
perform work on the national forest land cut over by the purchaser.

"(b) The Secretary of Agriculture shall prescribe standards for purposes
determining whether the purchaser's reforestation work is sufficient to retu
the cut over area to a productive condition. Any such work shall result in
necessary reforestation being completed within five years from the date
completion of the timber sale.".

TITLE II—PROVISIONS TO ENCOURAGE DOMESTIC SOFTWOOD LOG PROCESSING

DENIAL OF CERTAIN BENEFITS

SEC. 201. (a) Section 11 of the Internal Revenue Code of 1954 (relating to
imposed on corporations) is amended by adding at the end thereof the follow
new subsection:

"(e) INCOME FROM EXPORTED SOFTWOOD LOGS SUBJECT TO REGULAR RATE

"(1) IN GENERAL.—If any corporation has taxable income for the taxa
year which is attributable to sales or exchanges of softwood logs which
exported (whether or not by such corporation), the taxable income (to
extent so attributable) shall be subject to the tax at the rates and in
manner provided by this section.

"(2) SOFTWOOD LOGS.—For purposes of this subsection, the term 'so
wood logs' means—

"(A) any softwood log or cant which has a diameter inside the b
at the small end of 6 inches or more, and

"(B) any softwood square each side of which is 6 inches or mo

"(3) CERTIFICATION.—Under regulations prescribed by the Secretary,
subsection shall not apply to the taxable income attributable to the
or exchange of a softwood log if the taxpayer in good faith accept
certification from the person to whom the log is sold or exchanged that
log will not be exported.".

(b)(1) Paragraph (1) of section 995(b) of such Code (relating to dee
distributions from a DISC) is amended—

(A) by redesignating subparagraphs (E), (F), and (G) as subparagra
(F), (G), and (H), respectively,

(B) by inserting after subparagraph (D) the following new subparagra

"(E) the taxable income of the DISC for the taxable year attri
table to softwood logs (as defined in section 11(e)(2)),",

(C) by striking out "(D), and (E)" in subparagraph (G)(i) (as so
designated) and inserting in lieu thereof "(D), (E), and (F)", and

(D) by striking out "subparagraph (G)" in the last sentence and insert
in lieu thereof "subparagraph (H)".

(2) Paragraph (2) of section 995(e) of such Code is amended by striking out "and (D)" and inserting in lieu thereof "(D), and (E)".

(3) Subparagraph (B) of section 995(e)(4) of such Code is amended by striking out "50 percent" and inserting in lieu thereof "the sum of such qualified export gross receipts which are attributable to softwood logs (as defined in section 11(e)(2)) plus 50 percent".

(4) Subsections (e)(8) and (f) of section 995 of such Code are each amended by striking out "subsection (b)(1)(E)" each place it appears and inserting in lieu thereof "subsection (b)(1)(F)".

(c)(1) Except as provided in paragraph (2), the amendments made by this section shall apply to taxable years beginning after the date of the enactment of this Act.

(2) The amendments made by this section shall not apply with respect to income attributable to any sale or exchange if such sale or exchange is pursuant to a contract which, on the date of the enactment of this Act and at all times thereafter, is binding on the taxpayer.

FOREST SERVICE NURSERIES FUND

SEC. 202. (a) There is hereby established on the books of the Treasury of the United States a special fund to be known as the "Forest Service Nurseries Fund" (hereinafter in this section referred to as the "Nurseries Fund").

(b)(1) The Secretary of the Treasury shall, from time to time, transfer from the general fund of the Treasury to the Nurseries Fund amounts equal to the increases by reason of the amendments made by section 201 of this Act in the taxes under chapter 1 of the Internal Revenue Code of 1954 which are received in the Treasury.

(2) Transfers under paragraph (1) shall be based on estimates by the Secretary of the Treasury with proper adjustments in the amount of subsequent transfers to the extent prior estimates were less than or greater than the amounts required to be transferred.

(c)(1) Amounts in the Nurseries Fund shall be available, as provided by appropriation Acts, to the Secretary of Agriculture (acting through the Forest Service) to establish and operate nurseries to provide stock for the reforestation of public and private forest lands.

(2) Amounts appropriated from the Nurseries Fund for the purposes described in paragraph (1) shall be in addition to amounts which would otherwise be made available for such purposes.

CREDIT FOR FORESTRY EXPENDITURES

SEC. 203. (a) Subpart A of part IV of subchapter A of chapter 1 of the Internal Revenue Code of 1954 (relating to credits allowable) is amended by inserting after section 44C the following new section:

"SEC. 44D. CREDIT FOR FORESTRY EXPENDITURES.

"(a) ALLOWANCE OF CREDIT. In the case of an eligible taxpayer, there shall be allowed as a credit against the tax imposed by this chapter for the taxable year an amount equal to the greater of—

"(1) 25 percent of so much of the qualified forestry expenditures paid or incurred by the taxpayer during the taxable year as does not exceed $5,000, or

"(2) 10 percent of the qualified forestry expenditures paid or incurred by the taxpayer during the taxable year.

"(b) LIMITATIONS.—

"(1) MAXIMUM AMOUNT OF CREDIT.—The amount of credit allowed under subsection (a) to the taxpayer for the taxable year shall not exceed—

"(A) so much of the liability for tax for the taxable year as does not exceed $25,000 ($12,500 in the case of a married individual filing a separate return), plus

"(B) 90 percent of so much of the liability for tax for the taxable year as exceeds $25,000 ($12,500 in the case of a married individual filing a separate return).

For purposes of this subsection, the term 'liability for tax' means the tax imposed by this chapter for the taxable year reduced by the sum of the credits allowable under a section of this part having a lower number or letter desig-

nation than this section, other than the credits allowable by sections 31,
and 43.

"(2) Expenditures must apply to 1 acre or more.—No qualified fores
expenditures shall be taken into account under subsection (a) by the t
payer for any taxable year unless such expenditures are paid or incurred
such taxpayer during such year with respect to 1 acre or more.

"(3) Denial of double benefit.—No qualified forestry expenditures sh
be taken into account under subsection (a) by the taxpayer for any taxa
year if the taxpayer is entitled to take such expenditures into account a
deduction for any taxable year under any other provision of this chap
other than under section 611 (relating to depletion).

"(c) Definitions.—For purposes of this section—

"(1) Eligible Taxpayer.—The term 'eligible taxpayer' means any per
(A) who owns at the end of the taxable year not less than 25 acres of l
suitable for producing timber usable for the manufacture of wood produ
and (B) who during the taxable year did not receive or expend cost-shar
funds received under section 4 of the Cooperative Forestry Assistance Ac
1978 (16 U.S.C. 2103).

"(2) Qualified forestry expenditures.—The term 'qualified forestry
penditures' means any amount chargeable to capital account and paid
incurred for—

"(A) the planting of tree seeds or seedlings (other than tree seed
seedlings for any tree on which fruit or nuts are grown) in such spe
and numbers as are suitable for producing timber, including site p
aration for purposes of such plantings; or

"(B) the planting of any shelterbelt, including site preparation
purposes of such planting.

"(3) Shelterbelt.—The term 'shelterbelt' means any strip of living tree
shrubs (or both) established and maintained for the purpose of providing
wind erosion control, snow accumulation, or wildlife habitation.

"(4) Site Preparation.—The term 'site preparation' means the prepara
of an area for the planting of tree seeds or seedlings, including treatment of
and litter.

"(d) Special Rules for Controlled Groups, Etc.—For the purposes of
section—

"(1) Controlled group of corporations.—All corporations which
component members of the same controlled group of corporations sha
treated as one taxpayer for the taxable year. In any such case the credi
any) allowable under this section to any such member shall be its pro
tionate share of the expenditures giving rise to such credit. For purpos
this paragraph, the term 'controlled group of corporations' has the mea
given such term by section 1563(a), except that 'more than 50 percent'
be substituted for 'at least 80 percent' each place it appears in such subsec

"(2) Partnerships, proprietorships, etc., which are under com
control.—Under regulations prescribed by the Secretary, all trades or
ness (whether or not incorporated) which are under common control at
time during the taxable year shall be treated as one taxpayer for such
and the credit (if any) allowable under this section with respect to
trade or business shall be its proportionate share of the expenditures g
rise to such credit. The regulations prescribed under this paragraph
be based on principles similar to the principles which apply under parag
(1).

"(c) Carryover and Carryback of Unused Credits.—Any unused credit
a taxable year may be carried back to 3 taxable years preceding the taxable
and forward to 7 taxable years following the taxable year in the same ma
as investment tax credit carrybacks and carryovers under section 46(b)."

(b) The table of sections of such subpart A is amended by inserting afte
item relating to section 44C the following new item:

"Sec. 44D. Credit for forestry expenditures."

(c) The amendments made by this section shall apply to taxable years b
ning after the date of the enactment of this Act.

H.R. 5798

A BILL To amend the Internal Revenue Code of 1954 to provide a tax credit for qualified forestry expenditures that improve the productivity of privately owned lands, and for other purposes

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act shall be cited as the "Forestry Tax Incentive Act of 1979".

FINDINGS

SEC. 2. The Congress hereby finds and declares that—

(a) adequate supplies of timber and other forest resources are essential to the Nation,

(b) managed forest lands provide habitats for fish and wildlife, as well as esthetics, outdoor recreation opportunities, and other forest resources,

(c) private forest lands, particularly those owned by nonindustrial owners, hold the key to meeting increased future demands for wood and wood products,

(d) Federal incentives are a cost-effective means to increase the productivity of privately owned forest lands and their cost will be returned to the Treasury through increased employment and the economic development of rural areas,

(e) a favorable tax climate will contribute to private forest landowners' ability to make investments in forestry practices that improve the productivity of such land.

CREDIT FOR FORESTRY EXPENDITURES

SEC. 3 (a) Subpart A of part IV of subchapter A of chapter 1 of the Internal Revenue Code of 1954 (relating to credits allowable) is amended by inserting after section 44C the following new section:

"SEC. 44D. CREDIT FOR FORESTRY EXPENDITURES.

"(a) ALLOWANCE OF CREDIT.—In the case of an eligible taxpayer, there shall be allowed as a credit against the tax imposed by this chapter for the taxable year an amount equal to the sum of—

"(1) 75 percent of qualified forestry expenditures up to $5,000,

"(2) 50 percent of qualified forestry expenditures over $5,000, but not in excess of $15,000, plus

"(3) 25 percent of qualified forestry expenditures over $15,000, but not in excess of $25,000, plus

"(4) 10 percent of qualified forestry expenditures over $25,000, but not in excess of $50,000.

"(b) LIMITATIONS—

"(1) EXPENDITURES MUST APPLY TO 10 ACRES OR MORE.—No qualified forestry expenditures shall be considered for tax credits under subsection (a) for any taxable year unless such expenditures apply to areas of 10 acres or larger.

"(2) DENIAL OF DOUBLE BENEFIT.—No qualified forestry expenditures shall be taken into account under subsection (a) for any taxable year if the taxpayer takes such expenditures into account for purposes of a tax credit or deduction for any taxable year under any other provisions of this chapter, other than under section 611 (relating to depletion).

"(3) APPLICATION WITH OTHER CREDITS.—The credit allowed by subsection (a) shall not exceed the tax imposed by this chapter for the taxable year, reduced by the sum of the credits allowable under a section of this subpart having a lower number or letter designation than this section, other than credits allowable by sections 31, 39, and 43.

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"(4) PERSONS RECEIVING GOVERNMENT COST-SHARING FUNDS.—The taxpayer shall not be treated as having paid or incurred any qualified forestry expenditure which is made from funds received as cost-sharing payments through the forestry incentives program authorized by section 4 of the Cooperative Forestry Assistance Act of 1978 (16 U.S.C. 2103) or through State cost-sharing programs for improving forests.

"(c) DEFINITIONS.—For purposes of this section—

"(1) ELIGIBLE TAXPAYER.—The term 'eligible taxpayer' means any person who owns at the end of the taxable year not less than 10 acres of land which is capable of (A) producing crops of industrial wood, or (B) providing other forest resources.

"(2) QUALIFIED FORESTRY EXPENDITURES.—

"(A) In general, the term 'qualified forestry expenditure' means any amount paid or incurred by the taxpayer which is properly chargeable to the capital account for creating and enhancing vegetation on forest lands for the purpose of—

"(i) Forest growth and quality,
"(ii) Fish and wildlife habitat,
"(iii) Soil stabilization, or
"(iv) Outdoor recreation.

"(B) REGULATIONS.—The Secretary shall, after consultation with the Secretary of Agriculture, prescribe regulations detailing those management and conservation practices which qualify for purposes of this paragraph.

"(d) CARRYOVER OF UNUSED CREDITS.—Any unused credits for a taxable year may be carried forward to 5 taxable years following the taxable year in which the qualified forestry expenditures are incurred.

"(e) SPECIAL RULES FOR CONTROLLED GROUPS, ETC.—For the purposes of this section—

"(1) CONTROLLED GROUP OF CORPORATIONS.—All corporations which are component members of the same controlled group of corporations shall be treated as one taxpayer for the taxable year. In any such case, the credit (if any) allowable under this section to any such member shall be its proportionate share of the expenditures giving rise to such credit. For purposes of this paragraph, the term 'controlled group of corporations' has the meaning given such term by section 1563(a), except that 'more than 50 percent' shall be substituted for 'at least 80 percent' each place it appears in such subsection.

"(2) PARTNERSHIPS, PROPRIETORSHIPS, ETC., WHICH ARE UNDER COMMON CONTROL.—Under regulations prescribed by the Secretary, all trades or businesses (whether or not incorporated) which are under common control at any time during the taxable year shall be treated as one taxpayer for such year and the credit (if any) allowable under this section with respect to each trade or business shall be its proportionate share of the expenditures giving rise to such credit. The regulations prescribed under this paragraph shall be based on principles similar to the principles which apply under paragraph (1)."

(b) The table of sections of subpart A is amended by inserting after the item relating to section 44C the following new item:

"Sec. 44D. Credit for forestry expenditures."

(c) Subsection (b) of section 6096 of such Code (relating to designation of income tax payments to Presidential Election Campaign Fund) is amended by striking out "and 44C" and inserting in lieu thereof "44C, and 44D".

(d) The amendment made by this section shall apply to taxable years beginning after the date of the enactment of this Act.

SUMMARY

Present law

Corporate tax rates.—Generally, under present law, a graduated tax is imposed on the first $100,000 of taxable income of a corporation. In brackets of $25,000 in taxable income, the rates are 17, 20, 30, and 40 percent. A rate of 46 percent is imposed on taxable income in excess of $100,000. An alternative tax of 28 percent applies to corporate net capital gains (the excess of long-term capital gain over the net short-term capital loss) if lower than the corporation's regular tax rate.

With respect to timber held by a taxpayer for sale or use in the taxpayer's trade or business, the taxpayer may elect to treat the cutting of timber as a sale or exchange if the timber or the contract right to cut the timber has been held for more than 12 months (Code sec. 631(a)). If that election is made, the gain recognized from treating the cutting as a sale or exchange is eligible for capital gains treatment (Code sec. 1231(b)(2)).[1] Similar rules are also prescribed for the disposal of timber with a retained economic interest (Code sec. 631(b)).

Domestic International Sales Corporations.—Under present law, the profits of Domestic International Sales Corporations, or "DISCS", are not taxed to the DISCs but are taxed to the shareholders when actually distributed or deemed to be distributed. Under one of the qualification requirements, at least 95 percent of the corporation's gross receipts must consist of qualified export receipts. For this purpose, gross receipts from the sale of timber qualify as receipts from the sale of qualified export property. The President may by Executive order designate property as in short supply and thereby exclude it from qualification if he determines the supply is insufficient to meet requirements of the domestic economy.

Reforestation expenditures—Under present law, direct costs incurred in connection with reforestation of timberlands are treated as capital expenditures. (Treas. Regs. § 1.611-3(a). Reforestation costs for this purpose are those for site preparation (including gridling, herbicide applications, baiting of rodents, and bush removal), seed or seedlings, plus labor and tool expenses incident to planting or seeding. Depreciation on tractors, trucks and other equipment used in these activities must also be capitalized as a reforestation cost.[2]

These capitalized reforestation costs may not be depreciated but are recovered through a depletion deductions when the timber is harvested fifteen or more years later.

If a private owner of timberland receives funds from the Federal Government or State government under certain reforestation cost sharing programs, these funds are not included in income. In addition, the private owner of timberlands does not receive any depletion, depreciation or other deduction for his reforestation costs paid with these cost-sharing funds, and the owner's basis in the property does not reflect the amount of these payments.[3] These rules apply for grants made after September 30, 1979.

Where additional costs are incurred for clearing brush and unwanted trees after the planting or seeding of timberlands, these costs are currently deductible because they are in the nature of maintenance charges.[4]

Investment tax credit—Under present law, a credit against income tax liability is provided for a taxpayer's investment in certain types of depreciable business for a taxpayer's investment in certain types of depreciable business assets. Generally, the credit allowable is 10 percent of qualified investment.

The credit is generally not allowable with respect to timber since it is not depreciable property.[5]

Issues

The issues raised by the bills are:

(1) Whether the Secretary of Agriculture may require the purchaser of timber from national forest land to perform work on land cut over by the purchaser

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[1] The preference portion of a corporate capital gain may be subject to the 15-percent add-on minimum tax. However, in the case of timber, the amount which would otherwise be treated as a tax preference is reduced by the sum of one-third of the corporation's timber preference income plus $20,000 (Code secs. 57(a)(9)(C) and 57(e)). Reductions are required for computing the regular tax deduction allowable for purposes of the corporate minimum tax (Code sec. 56(d)) and a special tax carryover rule for timber is provided (Code sec. 56(e)).

[2] Rev. Rul. 75-467, 1975-2 C. B. 93.

[3] These rules, found in sections 126 and 1255 of the Code, were enacted under section 543 of the Revenues Act of 1978 (P.L. 95-600).

[4] Rev. Rul. 66-1 C. B. 59, indicates that such expenses are currently deductible. This ruling was modified by Rev. Rul. 71-228, 1971-1 C. B. 53. to indicate that costs of annual shearing of Christmas trees are also currently deductible. This latter ruling also follows the decision in *Daniel D. Kinley*, 51 T.C. 1002 (1969), *aff'd per curiam*, 70-2 USTC ¶ 9462 (2d Cir. 1970), acq. 1971-2 Cumm. Bull. 3.) See also, *Ransburg* v. *United States*, 281 F. Supp 324 (S.D. Ind. 1967) (current deduction for weed, brush and insect control expenses conceded by United States; the court also allowed a current deduction of expenses for annual shearing of Christmas trees).

[5] However, trees comprising a timber producer's seed orchard to produce seedlings qualify for the investment tax credit (Rev. Rul. 78-264, 1978-2 C.B. 9).

instead of requiring deposits of money to cover reforestation and forest improvement work.

(2) Whether alternative capital gains treatment and DISC deferral benefits should be denied with respect to taxable income attributable to sales or exchanges of softwood logs which are exported.

(3) Whether any additional taxes raised by special treatment of taxable income from exported softwood logs should be earmarked for a Forest Services Nurseries Fund.

(4) Whether an income tax credit should be allowed with respect to certain forestry expenditures.

Explanation of the bills

H.R. 4498

In general, the bill would (1) permit the Secretary of Agriculture to require a purchaser to perform work on national forest land cut over in lieu of making cash deposits for reforestation and forest improvement work, (2) impose the regular corporate rates on the taxable income of a corporation to the extent attributable to the export of softwood logs, (3) earmark for a Forest Services Nurseries Fund any increase in taxes attributable to the special taxation of taxable income from exports of softwood logs, and (4) provide a special income tax credit for specified percentages of a taxpayer's qualified forestry expenditures.

Consideration of the Bill by the Subcommittee on Forests of the Committee on Agriculture.—The bill, H.R. 4498, was jointly referred to the Committee on Ways and Means and the Committee on Agriculture. On July 19, 1979, the Subcommittee on Forests of the Committee on Agriculture approved the income tax credit provisions (sec. 203) of the bill in concept although it did not actually report the bill. Because this provision is not within the jurisdiction of the Committee on Agriculture, the subcommittee recommended that the Committee on Ways and Means hold hearings on that provision of the bill. The Subcommittee on Forests did not approve the provisions under which tax benefits would be denied for taxable income attributable to exports of softwood logs.

Taxable income from softwood log exports.—Under the bill, corporate taxable income attributable to sales or exchanges of softwood logs which are exported would be subject to the regular corporate tax rates and not eligible for capital gains treatment. This provision would apply with respect to softwood logs exported by the taxpayer or another person. However, the provision would not apply with respect to sales or exchanges of logs if the taxpayer in good faith accepts a certification from the purchaser that the logs will not be exported. For purposes of this provision, a softwood log means a softwood log or cant which has a diameter inside the bark at the small end of 6 inches or more, and any softwood square each side of which is 6 inches or more.

The bill also would provide that, in the case of a DISC, the taxable income attributable to softwood logs shall be deemed to be distributed as a taxable dividend to shareholders. Thus, the DISC deferral benefits would be denied for the taxable income attributable to export sales of softwood logs.

The increase in corporate taxes attributable to the preceding provisions would be earmarked for a special fund to be known as the Forest Service Nurseries Fund. Transfers of these amounts would be based on estimates by the Secretary of the Treasury with proper adjustments in the amount of subsequent transfers to reflect differences between estimated and actual receipts attributable to those provisions. Amounts in the fund would be available, as provided by appropriation Acts, to the Secretary of Agriculture (acting through the Forest Service) to establish and operate nurseries to provide stock for the reforestation of public and private forest lands.

Tax credit for forestry expenditures.—Under the bill, a credit against the income tax liability of an eligible taxpayer would be allowed. The amount of the credit would be equal to the greater of (1) 25 percent of the qualified forestry expenditures paid or incurred by the taxpayer during the taxable year that does not exceed $50,000[6] (a maximum credit of $12,500) or (2) 10 percent of the total such expenditures for the taxable year.

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[6] The bill provides a $5,000 limit upon qualified forestry expenditures which are taken into account for purposes of the 25-percent credit. However, it is understood that the sponsor of the bill intended the amount to be $50,000 and that the $5,000 amount resulted from a typographical error. In addition, it is understood that on July 19, 1979, the Subcommittee on Forests of the House Committee on Agriculture approved the credit provisions in principle with the understanding that the 25-percent credit limitation would be based on $50,000 in qualified expenditures.

For purposes of the provision, an eligible taxpayer is any person who owns at the end of the taxable year not less than 25 acres of land suitable for producing timber usable for the manufacture of wood products and who during the taxable year did not receive or expend cost-sharing funds received under section 4 of the Cooperative Forestry Assistance Act of 1978 (16 U.S.C. 2103). Qualified forestry expenditures eligible for the credit would mean amounts which are capitalized and paid or incurred for the planting of tree seeds or seedlings (other than for fruit and nut tree seeds and seedlings) in such species and numbers as are suitable for producing timber and the planting of any shelterbelt. Eligible expenditures would include the expenses of site preparation for the planting of tree seeds or seedlings or shelterbelt. Site preparation would include the treatment of soil and litter. For purposes of the bill, shelterbelt means any strip of living trees or shrubs established and maintained for the purpose of providing for wind erosion control, snow accumulation, or wildlife habitation. No expenditures are to be taken into account by a taxpayer for a taxable year unless expenditures are paid or incurred with respect to one acre or more. Further, no expenditures are to be taken into account if they are currently deductible by the taxpayer.

The amount of credit allowable for a taxable year would be subject to a tax liability limitation. For this purpose, the taxpayer's tax liability would be the amount of income taxed otherwise owed after reduction for all other nonrefundable credits having a lower section number than the proposed credit (i.e., the regular investment tax credit, energy credits etc.). For the first $25,000 in tax liability ($12,500 in the case of a married individual filing a separate return), the credit would be allowable dollar for dollar against tax liability. For amounts in excess of $25,000 (or $12,500), the amount of the credit would be limited to 90 percent of the tax liability in excess of $25,000 (or $12,500). Any unused credits could be carried back 3 years and carried forward for 7 years.

The provisions would be applied to a controlled group of corporations as if the group were a single taxpayer. The credit would be allowable to each member of the group in proportion to the qualifying expenditures made by each member. For purposes of this provision, a 50-percent control test would apply. Under Treasury regulations, other businesses under common control are to be treated as a single taxpayer.

H.R. 5978

This bill also would provide an income tax credit for forestry expenditures. It does not contain any provisions relating to exports of softwood logs.

Under the bill, the amount of the credit would be determined under the following table:

Qualified forestry expenditures	Rate (percent)	Maximum amount for each bracket
$1 to $5,000	75	$3,750
$5,001 to $15,000	50	5,000
$15,001 to $25,000	25	2,500
$25,001 to $50,000	10	2,500
Over $50,000	0	
Total maximum amount per taxpayer		13,750

For purposes of this provision, an eligible taxpayer means any person who owns at the end of the taxable year not less than 10 acres of land which is capable of producing crops of industrial wood or providing other forest resources. Under the bill, qualified forestry expenditures means amounts paid or incurred which are capitalized for creating and enhancing vegetation on forest lands for purposes of forest growth and quality, fish and wildlife habitat, soil stabilization, or outdoor recreation. For this purpose, no expenditures are taken into account for any taxable year unless the expenditures apply to areas of 10 acres or larger. Further, no expenditure is to be taken into account if it is currently deductible for the taxable year. Finally, a taxpayer will not be treated as having paid or incurred any qualified expenditures if they are made from funds received as cost-sharing payments through the Forestry Incentives Programs authorized by section 4 of the Cooperative Forestry Assistance Act of 1978 (16 U.S.C. 2103) or through State cost-sharing programs for improving forests.

The credit allowed would be limited to the tax liability for the taxable year. For this purpose, the tax liability limitation would be the tax otherwise owed reduced by other nonrefundable credits provided under code sections having a lower number or letter designation than this provision. Unused credits for a taxable year could be carried forward 5 years.

Special rules for controlled corporate groups or other business entities under common control are provided under the bill. These provisions are similar to those provided under H.R. 4498.

Effective dates

H.R. 4498—In general, the tax amendments would apply to taxable years beginning after the date of enactment of the bill. For purposes of the special rules relating to exports of softwood logs, a sale or exchange would be expected if made pursuant to a binding contract executed on or before the date of enactment.

H.R. 5978—The provisions of this bill would apply to taxable years beginning after the date of enactment of the bill.

Revenue effects

The estimated revenue effects for the provisions of the bills are set forth in the following table:

[In millions of dollars]

	Fiscal year—				
	1981	1982	1983	1984	1985
H.R. 4498:					
All taxable income from softwood log exports taxed at regular rates	4	14	26	42	52
Denial of DISC benefits	3	7	11	15	18
Credit for forestry expenditures	−8	−19	−22	−24	−26
H.R. 5798	−9	−23	−26	−27	−28

American Forestry Association,
Washington, D.C., July 3, 1980.

Hon. Daniel Rostenkowski,
Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives.

Dear Mr. Chairman: A prior commitment prevented me from submitting a statement at the June 26 hearing of your Subcommittee on H.R. 4498 (Mr. Weaver) and H.R. 5798 (Mr. Gudger) on the subject of tax incentives for qualified forestry expenditures. However, I would respectfully request that this letter be included in the hearing record.

The American Forestry Association is a citizen conservation organization of some 80,000 members, founded in 1875 and dedicated to the protection and sound management of our nation's public and private forest resources. Our concern for improved productivity of the majority of this country's forest land that comprises small non-industrial private forests prompts this letter in support of tax incentives to encourage reforestation on these ownerships.

According to the 1980 Resources Planning Act "Report to Congress" released on June 20 by the Forest Service of the U.S. Department of Agriculture, the demand for timber over the next fifty years will grow far more rapidly than will timber productivity under current levels of investment.

This supply-demand differential will result in continually rising timber prices until demand is dampened to meet supply levels. In other words, low productivity will result in continued inflationary lumber costs to the American public unless something is done.

The Forest Service report clearly shows that the land is capable of growing an ample supply of forest products, with the greatest potential for increased productivity being on the fifty-eight percent of our tree growing land held in small non-industrial private ownerships.

The non-industrial private forest is the key to achieving adequate timber growth to meeting rising needs in the next fifty years.

The problem is that most small landowners do not have the financial ability to make the needed reforestation efforts on their land. And yet, the trees we will need twenty-five and fifty years from now must be planted today or they will not be there when we need them.

There is no single simple solution to the problem. A series of regional conferences on small woodland management sponsored last year by the National Association of State Foresters surfaced at least nine different needs of small woodland owners, including better inventory information, marketing information, and more technical information and assistance. At the top of the list, as perceived by the landowners, is tax relief, including an investment credit or similar incentive to help with the initial costs of establishing new forest crops.

H.R. 4498 and H.R. 5798 are a clear response to this high priority need, and we commend Mr. Weaver and Mr. Gudger for their leadership in sponsoring these bills, and urge favorable consideration by this Subcommittee.

Narrowly viewed, the tax-credit issue might be characterized as merely a question of how much the private landowner should be subsidized to grow trees. In the broader perspective, however, we should be asking, "How much is it worth to help the small landowner devote his land to growing trees that the nation will need for homes, paper, fuelwood and other forest values during the next fifty years?"

What we are talking about is a partnership between the public and the small forest owner. He owns the land. The public needs the timber. In the end, the landowner will benefit when he sells the trees, but the public will also benefit through lower overall prices that reflect adequate timber supplies rather than increasing prices driven by short supply.

Nor should we overlook other benefits to be derived from keeping land in tree production. We are told that the nation is losing as much as three million acres of productive farm and forest land each year to urbanizations and related causes. A national agricultural lands study is currently being conducted by the President's Council on Environmental Quality and the U.S. Department of Agriculture to determine how to keep these lands in production.

One way is to restrict what the landowner may do through regulations. Another would be a costly program of public spending to acquire private land. A far better way, in our estimation, is to help the private landowner maintain the productivity of his land. Tax incentives which help the landowner put trees on his land are a positive approach that in the long run will generate more timber production, and at the same time, help maintain healthy, well-managed forest lands for soil and water protection, wildlife habitat and related values.

Tax incentives such as proposed in H.R. 4498 and H.R. 5798 are not the complete answer. But they could be the priming of the pump; the signal to the landowner that the vital first step toward the forests of the future must be the afforestation and reforestation of our tree growing land.

We therefore support the tax credit provisions of these bills and urge the Subcommittee to give the bills careful consideration and report out a bill which will provide this kind of assistance to the landowner . . . and to the public.

Sincerely,

REXFORD A. RESLER,
Executive Vice President.

[Mailgram]

OLD TOWN, MAINE, *June 30, 1980.*

Representative AL ULLMAN,
House of Representatives,
Washington, D.C.:

The Association of Consulting Foresters, in annual meeting assembled, at Cable, Wisconsin, did unanimously resolve to request the Ways and Means Committee, to favorably support for private forest land owners (who own 58 percent of the nation's commercial timberlands) the Forest Reforestation Bill (H.R. 5798) of Representative Gudger.

A tax reforestation incentive bill is in our opinion in the nation's best interest as it will increase the productivity of the nation's forests, improve the stewardship of these lands and thereby help meet the ever increasing wood and environmental needs of our nation.

ROBERT B. FISKE,
President,
Association of Consulting Foresters.

STATEMENT OF JOHN J. STEPHENS, VICE PRESIDENT AND GROUP EXECUTIVE, WOOD PRODUCTS AND RESOURCES GROUP, INTERNATIONAL PAPER CO.

Thank you for this opportunity to express International Paper Company's support for H.R. 4498.

I am John J. Stephens, Vice President and Group Executive for International Paper's Wood Products and Resources Group, one of five major businesses comprising the company. Wood Products and Resources is a billion-dollar business with 10,000 employees in 22 states.

We are responsible for land management, timber utilization, and applied forestry research relative to the company's 7,000,000 acres in three forested regions of the U.S.; the manufacturing and marketing of wood products, such as lumber and plywood, on a worldwide basis; and wood fiber procurement for our group's 24 lumber, plywood treated wood and cabinet plants as well as IP's 13 major pulp and paper mills in the U.S.

Additionally, our business group is responsible for what we call our Landowner Assistance Program (LAP). This program provides professional forestry help to the private, non-industrial landowners, who own most of America's commercial forest lands and are the major suppliers of wood fiber to our industry. I will explain LAP in some detail later, because small tree farmers are significantly important to IP's support of this legislation.

The heart of H.R. 4498 is up front incentives through an annual tax credit to landowners for reforestation expenses. These incentives address what we believe is the critical issue for the forestry enterprise: The need for major sources of new capital to increase wood fiber productivity.

Time is equally critical from the perspective of our nation's commercial forestlands, because we will be well into the 21st Century before seedlings planted today reach maturity. Reports from government, universities, and industry are overwhelming in predictions that by the year 2030 demand for wood products will more than double. Timber supply, on the other hand, will be only half again then what it is today.

In a recent updated assessment, the Forest Service lists total U.S. demands on the nation's timber resources will increase from the 1976 level of 13.1 billion cubic feet to 25.6 billion cubic feet in 2030. Supply was 12.1 billion cubic feet in 1976, and it is projected to be 21.2 billion cubic feet in 2030.

Clearly, there is a negative 4.4 billion cubic feet in the supply-demand equation. This negative balance means increased costs to consumers for the literally thousands of forest-based products. Most significantly, much of the cost increase will be in softwoods, the source of basic products for housing and communication.

The U.S. Forest Service has projected investment needs of $900 million a year for public and private non-industrial timberlands only through the 1980's just to keep up with wood fiber demands. The agency's report, under the Rangeland and Renewable Resources Act of 1976, predicted the investment figures would be over $1 billion a year by the turn of the century. If the Forest Service continues to receive inadequate funding as it has in the past, it is very unlikely these needed investment figures will ever be reached.

The Forest Industries Council in a recent study on forest productivity reports less than half of the forestland harvested is being reforested. The study was in 25 states, representing 83 percent of the 488 million acres of U.S. commercial forestlands. In the private, non-industrial sector, which owns 58 percent of these lands, only one in nine harvest acres are being "purposefully regenerated."

The Forest Industries Council also found almost 140 million acres in the 25 study states with investment opportunities in a 10 percent or better after-tax return to landowners. However, to encourage forest management on these lands would require an initial investment of $10.3 billion, which would increase annual growth by 10.9 billion cubic feet. H.R. 4498 would help provide the incentives for such huge forestry investments.

Such statistics dramatically illustrate the enormity of productivity needs and therefore investment needs, particularly in the private, non-industrial sector. These studies reinforce what our foresters long recognized: The overriding problem of reforestation is that the forestry investment, locked up for 25 to 50 years or longer, is very unattractive compared to alternatives with quicker capital recovery and return on investment.

The plight of the small landowners long has been a concern to International Paper, because as much as 70 percent of our wood fiber requirements come from this source. After over 30 years of informal assistance to small landowners, IP formalized the Landowner Assistance Program, which I mentioned earlier.

After only six years, LAP now has some 2,000 landowners enrolled, representing more than a million acres, in the 15 states where we have our land and timber organization. The program provides land management plans and normal professional counseling at no cost to the landowner. Under the program the landowner pays for various types of silvicultural work at cost, and our professional foresters advise them of the various incentives available for reforestation.

Other than industry programs such as LAP, there are few incentives for the small, private landowner to grow trees. No wonder statistics for this sector show they are reforesting less than half the time and what is planted goes virtually unmanaged.

Why invest in a tree crop when the cost of capital is far too high for expected returns? Forest production has all of the uncertainties of any crop. This is magnified by the long growing cycle, which is also a disincentive to entrepreneurs who may never live to see the harvest of their investments.

Compared to large landowners, the small tree farmer pays out more per acre to site prepare, plant trees, commercially thin his stands, and to remove cull trees—five times more on a 10-acre tract, for example, than on a 160-acre tract. Also, he gets lower return on his crop, because it is more economical to harvest large tracts.

The annual tax credits provided by H.R. 4498 will significantly improve the climate for investments by all private timberland owners. When landowners recognize their forests are profitable, they will grow trees as they grow any other crop. Planting and growing trees for profit is the best motivation for reforestation and protection of this Nation's forests that I know of.

One of the most exciting things in my land management role for IP is being able to utilize the productive capability of forestlands where our company operates. Forestry today is where agriculture was 30 years ago. Research in genetically superior trees, fertilization, soils and the use of natural fungi for incredible tree growth, all promise much more wood fiber per acre. These improvements, coupled with technological advances in planting, harvesting, and wood products manufacturing, can assure the fiber for products we need in perpetuity.

The bright future for forestry, however, again depends greatly on incentives to landowners for the high risk investments that must be made now. Congressman Weaver's bill is a major step in this direction.

The 25 percent investment tax credit on the first $50,000 of capitalized reforestation expenditures each year will appeal to the small landowner. Cash flow is typically modest for small tree farmers, who have a lesser opportunity to achieve the benefits of capital gains to the extent of the larger landowner. And, the 10 percent provision on amounts over $50,000 will attract capital to reforest marginal timberlands and afford opportunities for more widespread use of new technology and resuts of forestry research.

In short, we at International Paper believe H.R. 4498 is conceptually on target and potentially a major piece of legislation to assure Americans the timberland resources we all need.

We thank you for this opportunity to support H.R. 4498, and you have our assurance of enthusiastic assistance in educating tree farmers on the benefits available from this bill.

National Association of Home Builders,
Washington, D.C., June 25, 1980.

Hon. Daniel Rostenkowski,
Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives.

Dear Mr. Chairman: On behalf of the more than 124,000 members of the National Association of Home Builders (NAHB), I am writing to offer our strong support for H.R. 4498, introduced by Chairman Jim Weaver. NAHB believes that the bill is a positive step towards satisfying short and long range timber supply needs and towards alleviating the projected spiral in lumber prices in this decade.

During this decade, approximately 11 million more Americans will reach the prime homebuying age of 30 than did in the 1970's—a record housing demand

At the same time, trends in timber supply bode ill for meeting this demand, even with more drastic increases in lumber prices than were experienced in the 1970's. Projected significant declines in harvests on private tiberlands in the Northwest, declining timber production in Canada and rising levels of log exports will exacerbate our timber supply problems during this decade.

In 1979, log exports reached a record level of 3.8 billion board feet—a 50 percent increase in five years. This volume of timber would have provided enough lumber for over 320,000 new homes. Not only do log exports have a negative impact on supply, but they force domestic processors into competition with foreign purchasers and thereby inflate timber prices. NAHB believes that the benefits of Domestic International Sales Corporations (DISC's), by creating an additional incentive to export, have contributed to these timber supply and price problems. NAHB questions the wisdom of policies which encourage the export of a commodity which is in short supply on domestic markets. The Congressional Budget Office in a February 1980 report entitled "Reducing the Federal Budget: Strategies and Examples" discussed the repeal of all DISC provisions as an option to be considered in the effort to balance the budget. NAHB believes that a substantial revenue gain would result from the repeal of DISC benefits on exported timber as provided for in H.R. 4498.

In reference to the tax credit provisions of H.R. 4498 and to H.R. 5798, adequate reforestation and stand improvement of our private non-industrial forest lands are critical if they are to contribute their appropriate share to our longer range timber needs. The recently announced Resources Planning Act (RPA) Program recognizes this need by calling for a shift in the focus of long range timber production to our private non-industrial lands. America has an enormous, relatively untapped reserve of softwood sawtimber on its private non-industrial lands. The relatively small forest land owners are often not likely to make the investments in planning, maintenance, stand improvement and especially reforestation that are necessary for productive forestry. NAHB believes that the tax credits provided in H.R. 4498 for qualified forestry expenditures would stimulate needed investments in private forestry and allow private nonindustrial lands to contribute a greater share of our timber supply needs. According to Forest Service analysis, H.R. 4498 would provide the same benefit to the individual landowner as H.R. 5798 but at less cost to the federal treasury.

The recently announced RPA Program and the just released study by the Congressional Budget Office on national forest timber sales both project that the lumber price spiral of the 1970s will continue in the 1980s. CBO projects that lumber prices will rise at an average annual rate of 13.3 percent during this decade. An effort to control increasing log exports by removing DISC provisions from exported timber and to promote increased harvests on our private non-industrial lands by providing tax credits for forestry expenditures could help moderate this projected lumber price spiral with its negative implications for homeownership opportunities in the 1980s. NAHB strongly supports H.R. 4498.

Sincerely,

MERRILL BUTLER,
President.

FORESTRY DEPARTMENT,
OFFICE OF STATE FORESTER,
Salem, Oreg., June 19, 1980.

Congressman AL ULLMAN,
Longworth House Office Building,
Washington, D.C.

DEAR CONGRESSMAN ULLMAN: Soon you will be hearing testimony on HR 4498 and HR 5798 which would provide income tax credit incentives for practicing intensive forest management. We believe in the basic concepts of these bills and recommend that you give them consideration.

The people of Oregon are faced with a very frustrating situation in managing our forest resources. From surveys, we know that Oregon will experience a substantial decline in timber supply (at least 22 percent below our current harvest level) in the next 20 years * * * and at the same time our Nation will double it's demand for wood products. Yet while viewing this supply-demand projection, we are permitting excellent forest land to remain unproductive.

Why? The reason is simply because some forest landowners (many of them small woodland owners) do not have the front-end money to make the heavy investment it takes to convert brush land into thrifty, growing forests. The task is not only expensive * * * it requires a long wait for any economic return.

Thus we have a need to provide a new incentive to these forest landowners. We think an income tax credit has many advantages. It is efficient because the funds are not circulated through a bureaucracy * * * there is instant investment. It is economical because by raising a crop of timber there is greater eventual tax revenue for the community as well as stable employment, usable products, and an improved environment. It is effective because people basically want to be good land stewards and will respond to the opportunity. I understand the Country of Brazil has had great success in gaining reforestation using this incentive.

During the 1979 Legislature, Oregon enacted a 10 percent State income tax credit for reforesting underproductive woodlands. While we were pleased with the acceptance of this concept, we do not feel it went far enough as an incentive. This month, a legislative interim committee agreed and will recommend increasing this income tax credit to 50 percent of reforestation cost.

Although a tax credit may somewhat reduce immediate tax revenues, it is a good investment in the future. It is also a necessary investment, if we are to meet the Nation's demands for wood products.

Therefore, we encourage you to examine HR 4498 and HR 5798 and give them your support.

Sincerely,

William P. Holtsclaw,
Deputy State Forester.

Statement of the Southern Forest Products Association

Gentleman, the Southern Forest Products Association represents lumber manufacturers in the states of Alabama, Arkansas, Florida, Georgia, Louisiana, Mississippi, North Carolina, Oklahoma, South Carolina, Texas, Tennessee and Virginia. The supply of the raw material needed to make our products is the subject of the hearings on H.R. 4498, and we would like to present our view on the needs of our industry.

In the 1979 Resources Planning Act (RPA) Draft Assessment, the Forest Service projects domestic demand for lumber, plywood and pulpwood will more than double by the year 2030. The Assessment concludes that without major improvements in forest productivity, this demand increase will result in increased prices for domestic wood products, making them less competitive in domestic and world markets and adding to the nation's inflationary problems.

The Forest Service also forecasts a substantial shift in softwood timber production from the West to the South during that period of time.

Without an increase in forest productivity, particularly on the nonindustrial privately owned acreage, price increases due to the shortage of raw materials will prevent wood and wood products from aiding in the balancing of the trade defict, and in fact will damage our position by increasing our reliance on foreign imports.

The impending shift to the South as the Nation's focal point of forest products manufacture is noteworthy and inevitable. Already the South is providing one-third of the nation's softwood lumber, two fifths of its softwood plywood and two-thirds of its pulpwood.

Seventy-three percent of the South's 192 million acres of commercial forestland are held by nonindustrial private owners. These are the folks to be affected by the bill before the committee today, and it is among this class of ownership that the greatest need for incentives exists. The long term nature of the investment discourages older owners, and in fact the younger owners too. It takes 20 to 40 years to get any return to speak of and looming inheritance taxes, and risks associated with disease, fire and insects, frighten the conscientious investor. Estate tax reform must be considered in the near term. The repeal of the "Carryover Basis Rule" was a step in the right direction, but more work to protect the estate of an investor from confiscatory taxation will be necessary if serious long term investment is to be advocated.

The private landowner, because of the reluctance to tie up capital in long term investments, must be provided an up-front monetary incentive if we are to persuade him to invest in tree growing.

An investment tax credit like the one in Rep. Weaver's bill would help get trees planted. If a man could invest, and at the time he does so he lessens his tax liability, there then exists a double reward. An immediate (by next April 15) reduction on his federal income tax, and the long term reward associated with the investment. By its very nature it is a supply side inducement. The landowner gets an immediate economic advantage to produce a scarce commodity for the next generation's use, which in many instances he will not live to see.

It is up to the tax writing bodies of this Congress and the ones that follow to decide at what level the incentives discussed will perform the greatest good. It is our opinion that any investment in the productivity of our nation's woodlands and the productive capacity of the nation should be given preferential treatment if we are to reverse the continuing decline in our competitiveness abroad. The wheels of industry are greased with capital, and withholding tax preferential treatment from any source of capital treatment is a distinct and shortsighted detriment to greater productivity.

However, we are not unmindful of the politics that enter into the legislative process, and urge this committee to act favorably on some proposal to provide the much needed grease to our wood-making machine.

We see the following methods as a reasonable one to accomplish this objective:

1. Retain the capital gains treatment of timber income. Since the inception of this program in 1944, there has been a huge and continuous increase in the supply of softwood timber; that is, until the drastic increases in capital gains rates in 1969. Fortunately, the rate was reduced, albeit not to the pre-1969 levels, in the Revenue Act of 1978. Granted, other programs such as the Soil Bank did much to provide this wood production, but even critics will agree that capital gains treatment was in large measure responsible; and,

2. Eliminate disincentives to investment. This would include the preservation of private property through sizable reductions in the estate taxes due, and the removal of Federal intrusion in the private decision making process through the termination of land use planning via regulation; and,

3. The enactment of up-front investment incentives which will provide the landowner the encouragement to overcome his immediate objections. The most effective of these, we think, is provided by an investment tax credit on timber investments. We also strongly encourage the committee to consider the addition of an additional tax treatment now included in S. 100, a bill now before the U.S. Senate, which allows amortization of the entire investment over a seven-year period. This amortization would, of course, be subtracted from the basis of the taxpayer and would be recovered when his trees were harvested. This would get trees planted.

Trees must be given treatment which considers the special circumstances surrounding their nature. They take years to grow, and may pass through several estates before harvest. They are expensive to plant (site preparation and planting may cost over $100 per acre and costs are going up all the time). They are subject to risks from fire, insects and disease, and in some states confiscatory local property taxes.

If nature is allowed to take its course and as trees are harvested they are not replanted, the forest of the United States will not meet our domestic needs and certainly not those of foreign markets. In fact, we may see scarcities of wood products much like those recent shortages in petroleum products. We can't afford this, and we don't have much time to make these very necessary decisions. Thank you for giving us the opportunity to express our views.

Wood Energy Institute,
Washington, D.C., June 25, 1980.

Re H.R. 4498, reforestation tax credit bill.

Hon. Daniel Rostenkowski,
Rayburn Building,
Washington, D.C.

Dear Congressman Rostenkowski: In lieu of testimony before your Subcommittee, the Institute would like to submit this letter in support of Mr. Weaver's Bill. Our statement herein compliments an earlier endorsement on the Senate side of Mr. Packwood's Bill, H.R. 1212.

Simply stated, there is nothing more important to the future of the wood energy industry, and our companions in the forest products and paper industries, than doing whatever possible to insure the future, adequate supply of the wood resource. Toward that end, for example, we are bringing all of the Institute's resources to bear upon our support of Mr. Weaver's Wood Utilization Bill. Testimony in support of that legislation graphically illustrates the vast potential of the "wood alternative" for this country's energy needs, to wit, that waste wood and slash can produce 4–5 quads of renewable energy per year. This is more than our current nuclear output, and most interestingly, comes from sources not required by the other wood-related industries.

At the same time, we see the reforestation tax credit proposals as being an important "arm" of the multi-pronged efforts required to foster good forest management techniques. Looking at Mr. Weaver's measure, it is highlighted by:

(1) An investment tax credit for qualified reforestation expenditures;

(2) A 25 percent credit for expenditures up to $50,000, with 10 percent allowed for those over $50,000.

Unlike the Packwood Bill, the Weaver Bill presently does not contain a provision pertaining to seven-year amortization for capital costs, but I am informed that this language would be acceptable to him.

The importance of this legislation is that there are hundreds of thousands, perhaps millions, of individual woodlots in this country whose wood resource is being totally unutilized. The Weaver Bill, in conjunction with the current move toward coops, could create the incentive for individual landowners and farmers to effectively market their wood and rapidly reforest this renewable resource.

We draw a parallel with the tax credit for wood-burning devices which, although provided for in Sections 201–3 of the Windfall Profits Tax Act, has yet to be enacted by the Secretary pursuant to President Carter's personal pledge in his "Phase III" energy speech during April 1979 in Portsmouth, New Hampshire. The 1979 DOE study indicated that a 15 percent credit on wood stoves would save 92 million barrels of oil per year, and in light of the recent OTA findings concerning DOE's lack of commitment to energy conservation, this Institute has taken the position that the Government should encourage the people to conserve through implementation of the wood energy tax credit.

Comparably, the reforestation tax credit may well be to USDA what the wood energy tax credit is to DOE. Although WEI would be the first to say that we have enjoyed an excellent working relationship with the Forest Service, we are philosophically persuaded that this Nation's energy and resource problems will be more solved by collective numbers of "micro" decisions, rather than the "macro" approach of large-scale governmental programs. What we need are government initiatives that will facilitate individual efforts.

Mr. Weaver's Reforestation Tax Credit Bill is the type of vehicle we are looking for. Again, let's encourage the people to more efficiently manage this country's private woodlots, while the Forest Service exercises its complimentary role in the National Forests.

Sincerely yours,

Terry Ellsworth,
Director, Government Affairs.

H.R. 4511

A BILL To amend the Internal Revenue Code of 1954 to provide that the taxable income of a homeowners association shall be subject to the same graduated rates of tax as a corporation

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) the second sentence of paragraph (1) of section 528(b) of the Internal Revenue Code of 1954 (relating to tax imposed with respect to certain homeowners associations) is amended to read as follows: "Such tax shall consist of a tax computed as provided in section 11 as though the homeowners association taxable income were the taxable income referred to in section 11."

(b)) The amendment made by subsection (a) shall apply to taxable years beginning after December 31, 1978.

H.R. 6855

A BILL To amend the Internal Revenue Code of 1954 to tax certain homeowners associations as corporations

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That part VII of subchapter F of chapter 1 of the Internal Revenue Code (referring to certain homeowners associations) is amended by striking the second sentence of section 528(b)(1) and inserting in lieu thereof the following sentence:

"Such tax shall consist of the tax computed as provided in section 11 as though the homeowners association were a corporation and as though the homeowners' association taxable income were the taxable income referred to in section 11."

SUMMARY

Present law

Homeowners associations.—Under present law, a qualified homeowners association (a condominium management association or a residential real estate association) may elect to be treated as a tax-exempt organization (Code sec. 528). If an election is made, the association will not be taxed on "exempt function income." Exempt function income means membership dues, fees, and assessments received from persons who own residential units in the particular condominium or subdivision and who are members of the association.

The association will be taxed, however, on income which is not exempt function income. For example, any interest earned on amounts set aside in a sinking fund for future improvements is taxable. Similarly, any amount paid by persons who are not members of the association for use of the association's facilities, such as tennis courts, swimming pools, golf courses, etc., is taxable. Further, any amount paid by members for special use of the association's facilities, the use of which would not be available to all the members as a result of having paid the membership dues, fees, or assessments required to be paid by all members of the association, will be taxable. For example, if the membership dues, fees, or assessments do not entitle a member to use the association's party room or to use the swimming pool after a certain time period, then amounts paid for this use are taxable to the association.

Deductions from nonexempt income are allowed for expenses directly related to the production of such income, and a $100 deduction against taxable income is provided so that associations with only a minimal amount of taxable income will not be subject to tax. However, a net operating loss deduction is not allowed, and the special deductions for corporations (such as the dividends received deduction) are not allowed.

A homeowners association is taxed on its taxable income at the highest corporate rate (46 percent). If the association has net long-term capital gain, the tax rate is 28 percent for determining the association's alternative tax for capital gains.

Corporate tax rates.—Under present law, a corporation is taxed at graduated rates on the first $100,000 of taxable income. The corporate rates are 17 percent on the first $25,000 of taxable income, 20 percent on the next $25,000, 30 percent on the next $25,000, 40 percent on the next $25,000, and 46 percent on all taxable income above $100,000. The alternative tax rate for capital gains is 28 percent.

The Code contains rules to prevent abuse of the graduated rate structure. A controlled group of corporations is limited in the aggregate to a maximum of $25,000 of taxable income in each of the rate brackets below the 46 percent bracket (Code sec. 1561). These rules are used to prevent income splitting by such commonly controlled corporations.

Issues

The issues are whether the taxable income of a homeowners association should be taxed at rates less than the highest corporate tax rate and, if so, what is the appropriate rate (or rates).

Explanation of the bill

The bill would provide that the taxable income of a homeowners association would be subject to the same graduated rates of tax as would a corporation's taxable income.

Effective date

The provisions of the bill would apply to taxable years beginning after December 31, 1978.

Revenue effect

It is estimated that this bill would reduce budget receipts by $8 million in fiscal year 1981 (due to the retroactive effective date) and $4 million per year thereafter.

Other possible issues for subcommittee consideration

The subcommittee may wish to consider the following issues related to this bill. The basic rationale for the tax treatment of homeowners associations in the Code is that activities which would not be taxed if engaged in by homeowners individually should not be subject to tax when the individuals band together in an association. An extension of this principle would appear to be that the rate of taxation on invested funds of the association should not greatly exceed the rate that would be imposed on the funds if they were invested by individual members of the association.

On the other hand, taxation of an association at the regular corporation rates would generally result in the taxation of this income at a rate of 17 percent. Members of homeowners associations are likely to be in higher tax brackets. In addition, there are apparently no rules which would prevent abuse of the graduated rate structure by commonly controlled or related homeowners associations. The tests for commonly controlled corporations would not appear to be effective in nonprofit corporations which do not normally have stock ownership. Also, as is the case with political organizations, there appear to be almost no barriers to prevent the multiplication of organizations in order to minimize the tax burden.

In addition, if the graduated rates are to apply, the subcommittee may wish to consider whether the $100 deduction against taxable income should be repealed.

STATEMENT OF HON. NORMAN Y. MINETA, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. Chairman, I want to thank you and the rest of the Subcommittee members for focusing your attention on H.R. 4511, a bill to correct the tax rate for homeowner associations. I also want to thank our colleague, Representative Cec Heftel, for his keen interest in and active support of H.R. 4511.

The problem, Mr. Chairman, is basically one of discrimination in the tax code. Large homeowner/condominium associations can pay taxes at a lower rate than smaller associations.

The Tax Reform Act of 1976 included a provision which clarifies the tax status of homeowner association as a form of a corporation. The Act, however, allows an association the option of using one of two methods for calculating tax liability. One is as a regular corporation, or essentially the same vague and confusing method which all associations used before the Tax Reform Act of 1976. The other method, created by the 1976 Act, limits the types of income subject to income tax—and requires far less paperwork than the regular corporate method—but subjects associations to the highest corporate rate of 46 percent.

The problem is that many large homeowner associations may find it advantageous to continue to use the regular corporate tax method, despite the increased paperwork, to lower their overall tax burden.

Larger associations can afford professional tax advice, and, since the status of associations as a corporation is unclear, accountants can use various accounting devices to significantly lower an association's taxable income, perhaps to zero. Further, the taxable income is subject only to the graduated corporate tax rate.

Yet, smaller associations are not in a position to hire professional tax counsel, and are left with the option of using a much simpler tax return form, but paying a much higher tax rate than larger associations which use the regular corporate tax method.

On March 4, 1980, the Department of Treasury spoke in opposition to a bill identical to H.R. 4511, S. 2167, before the Senate Finance Committee. In its testimony, Treasury was concerned about a possible incentive the lower graduated corporate tax schedule might create for associations to build large investment portfolios. Yet, where is the incentive for homeowner associations, which are controlled by homeowners and are not run for profit, to build investment portfolios? What justification, outside of the need to set money aside for future maintenance, would an association board of directors use to explain to members the building of such an investment portfolio?

We are reaching too far here, I think, into abstract tax law, and not recognizing the practical aspects of association finance. I do not understand how fees from renting out a clubhouse, or profits from vending machines could generate enough revenue to justify even thinking in terms of an "investment portfolio." Rather, we are talking about, for most associations, simple savings and checking accounts.

Also in its statement before the Senate Finance Committee, Treasury notes that homeowner associations, before passage of the graduated corporate tax schedule in 1978, were not allowed to use the pre-1979 surtax exemption. It was thus out of consistency with previous law that associations were subject to the 46% tax rate on all taxable income. Yet, there is no legislative history explaining why homeowner associations were not allowed to use the surtax exemption in the first place. In fact, Treasury, in a letter to Representative Don Edwards, states, "A review of the legislative history does not indicate why the highest corporate rate was used." (letter attached)

In sum, I want to stress, Mr. Chairman, that the larger, wealthier associations can probably afford to pay little or no taxes while smaller associations, which lack the resources to hire professional tax counsel, must pay almost half of their modest taxable income to the government. I simply do not perceive a situation where associations, by virtue of the changes in H.R. 4511, would be encouraged to build large investment portfolios. Finally, there is no legislative history for subjecting homeowner associations to the highest corporate income tax rate.

I urge the Subcommittee to support H.R. 4511 for the sake of equity for homeowner and condominium associations.

Department of the Treasury,
Internal Revenue Service,
Washington, D.C., April 27, 1979.

Hon. Don Edwards,
House of Representatives,
Washington, D.C.

Dear Congressman Edwards: This is in response to your correspondence of April 5, 1979, on behalf of Branham Homeowners' Associates Inc. and on behalf of Contempo Homeowners Association. You request that we inform you of the most recent provisions of the Internal Revenue Code of 1954 pertinent to these inquiries.

Section 528 of the Internal Revenue Code of 1954 gives homeowner associations, including condominium management associations, the option to be taxed at the regular corporate tax rates or to elect to be treated as a tax-exempt organization. If the association does not elect to be treated as a tax-exempt organization, the tax rates to be applied on all of its income are the regular corporate tax rates set forth in section 11 of the Code. If the association elects to be treated as a tax-exempt organization, it is not taxed on its "exempt function income". Such income includes membership dues, fees and assessments for association member-owners of residential units in the particular condominium. The tax-exempt organization would however be taxed at the highest corporate tax rate under section 11(b) of the Code on its non-exempt function income (for example, fees collected from third parties for use of condominium property). The highest corporate tax rate under section 11(b) of the Code (which is applicable to tax years beginning after 1978) is 46 percent.

The Revenue Act of 1978 made changes in the corporate tax rates which are reflected in the treatment of homeowners' associations. Prior to the Revenue Act (for taxable years before 1979), homeowners' associations which elected to be treated as tax-exempt organizations were subject to normal corporate tax rates rates on non-exempt income (20 percent of income less than $25,000 and 22 percent of the excess, plus a 26 percent surtax) but without benefit of the surtax exemption of $50,000. The Revenue Act of 1978 abolished the surtax and substituted a five-step tax rate structure, and also changed the taxation rate of homeowners association electing tax-exempt status to the highest corporate rate, 46 percent, on non-exempt income for taxable years after 1978. Therefore, for both pre-1979 taxable years and post-1978 taxable years, homeowners' associations are taxed on its non-exempt income at the highest corporate rates. A review of the legislative history does not indicate why the highest corporate rate was used. S.R. 94–938, 94th Cong. 2nd Session (1976) at 393. Any change in tax rates regarding homeowners' association, however, must occur through legislation.

We hope that the information provided assists you in responding to your constituents.

Sincerely yours,

JOHN L. CRAWFORD,
Chief, Corporate Tax Branch.

STATEMENT OF ROBERT M. MEISNER, ESQ., BIRMINGHAM, MICH.

I, Robert M. Meisner, am an attorney located at 30100 Telegraph Road, Ste. 276, Birmingham, Michigan, 48010. I am a graduate of the University of Michigan and the University of Michigan Law School and I am licensed to practice in the State of Michigan and the Federal Courts. I am offering this Testimony in support of the passage of House Bill 4511 which would provide graduated rates for the payment of corporate income taxes by condominium and other homeowner associations.

As a practitioner who represents nearly 100 condominium associations, I am aware of a difficulty experienced by the Board of Directors in preparing budgets and raising the necessary funds incident to the proper operation of a condominium association. Many times the question of taxes on interest earned by the association is a focal point of discussion by the Board of Directors. In my opinion, a properly run condominium association must have adequate reserves to meet future contingencies. Moreover, the Condominium Act of 1978 for the State of Michigan requires a minimum ten percent reserve of the budget on a noncumulative basis. Accordingly, condominium associations are required to establish reserves for replacement of common areas. In that regard, proper management of those monies and reserves requires that same be invested in interest bearing accounts. It would seem, therefore, only fair that the associations be not penalized, through the tax laws, for putting aside funds which are mandated by statute and which comply with sound business procedures in regard to the operation of their association. It is my understanding that House Bill 4511 serves to correct the inequity which presently exists because of the high corporate tax rate which an association is forced to pay on interest and other "income" which it earns. Typically, of course, the condominium association is a non-profit corporation and there is no basis in equity, in my opinion, for it to be penalized in that capacity.

I urge, therefor, that the House and Senate move quickly to pass the proposed legislation encompassed in House Bill 4511. Should any of the members of Congress have any questions concerning this Testimony, please contact me.

UNITED CONDOMINUM OWNERS OF MICHIGAN,
Redford, Mich., June 18, 1980.

MEMBERS OF THE SELECT REVENUE MEASURES SUBCOMMITTEE,
House Ways and Means Committee,
House of Representatives.

DEAR SUBCOMMITTEE MEMBERS: United Condominium Owners of Michigan (UCOM) would appreciate your including this testimony in the record for HB 4511—the condominium income tax equalization bill.

Condominium associations have been discriminated against far too long with respect to taxation of their "income." All other corporations are taxed on a graduated basis beginning with 17 percent and moving on up to 46 percent for those with income in exces of $100,000. Condominium associations, however, must pay 46 percent immediately (when filing on 1120-H) on their income regardless of how much or how little. Of course this is unfair, and HB 4511 seeks to right this wrong.

Our organization is fully in favor of this attempt to equalize the tax provisions for condominimums, and we urge each of you to consider the injustice that has been perpetrated in the past (possibly because of ignorance of how condominium associations work) and to support the legislation introduced to the House as HB 4511.

Sincerely,

ELEANOR M. PALUBIN,
President.

H.R. 4544

A BILL To amend the Internal Revenue Code of 1954 relating to estate taxes to provide that the election to use the alternate valuation date may be made on a return that is filed late

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) section 2032(c) of the Internal Revenue Code of 1954 (relating to election of alternate valuation) is amended to read as follows:

"(c) TIME OF ELECTION.—The election provided for in this section shall be exercised by the executor on his return not later that the time such return is filed.".

(b) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendment made by subsection (a) of this Act shall apply with respect to estates of decedents dying after December 31, 1977.

(2) TRANSITIONAL RULE.—At the election of an executor (made within 90 days after the enactment of this Act in such manner as the Secretary of the Treasury or his delegate may by regulations prescribe), the amendment made by subsection (a) of this Act shall apply with respect to an estate of a decedent dying before January 1, 1978, if an election under section 2032(c) of the Internal Revenue Code of 1954 (relating to election of alternate valuation) had been indicated on the first estate tax return filed with respect to the estate of the decedent. If an election is made under this paragraph and if the assessment of any deficiency for estate tax is prevented on the date of such election, or at any time within 90 days after such election, by the operation of any law, or rule of law, such assessment may, nevertheless, be made within 90 days after such election.

SUMMARY

Present law

Under present law, the executor of a decedent's estate may value the property in the gross estate as of the date of the decedent's death or the "alternate valuation date," generally six months after the date of the decedent's death (Code sec. 2032). Alternate valuation provides estate tax relief when property in a decedent's estate declines in value shortly after the decedent's death. Alternate valuation must be elected by the executor on an estate tax return filed within nine months of the date of death or any period of extension granted by the Internal Revenue Service (Code sec. 2032(c)).[1]

Under Code section 6081, the Internal Revenue Service may grant an extension of time to file an estate tax return. Except in the case of taxpayers who are abroad, the Internal Revenue Service has no discretionary authority to grant an extension exceeding six months.

Issue

The issue is whether an executor should be permitted to elect alternate valuation on an estate tax return that is not timely filed.

Explanation of the bill

The bill would permit the election of alternate valuation on a timely filed estate tax return or the first late return filed. In the case of a timely filed return, an executor would not be permitted to change the election after the due date for the return has passed. In the case of a late return, the election could not be changed after the first return has been filed.

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[1] An executor may elect alternate valuation by checking a box on the second page of Form 706, United States Estate Tax Return. An executor's failure to check the appropriate box on a timely filed Form 706 may not prevent the use of alternate valuation if the entries on the form are otherwise consistent with an election of alternate valuation (Rev. Rul. 61-128, 1961-2 C. B. 150).

Effective date

The provisions of the bill would apply to estates of decedents dying after December 31, 1977.[2]

The bill includes a transitional rule applicable to estates of decedents dying before January 1, 1978. The transitional rule would permit an effective election of alternate valuation to be made within 90 days after the enactment of the bill, if an election of alternate valuation had been indicated in the first estate tax return filed. If an election is made under the transitional rule, an assessment of a deficiency in tax may be made within 90 days of the election although such assessment is otherwise barred. The transitional rule would benefit the estate of the late Sylvia Buring of Tennessee.

Revenue effect

This bill would have a negligible effect upon budget receipts.

Other congressional action

The Senate Finance Committee has approved an identical provision, which is contained in H.R. 2492 as amended (S. Rept. 96-532).

STATEMENT OF HON. ROBIN L. BEARD, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TENNESSEE

Mr. Chairman and Members of the Subcommittee, I am pleased to appear before you in support of H.R. 4544, a bill which I introduced to amend the Internal Revenue Code relating to estate taxes. This bill would permit the "alternative valuation date" election to be made on an estate tax return that is for some reason not filed on time.

The unfair provisions of the present law on this subject have resulted in a severe hardship to the estate of a former resident of Tennessee. Senators Baker and Sasser have introduced an identical bill (S. 541) in the Senate in order to correct this inequity. As you may know, the Senate Committee on Finance has favorably reported the Senate Bill (which is now part of House-passed bill H.R. 1212).

For many years, the tax law has permitted an estate to value property owned by a decedent either on the date of death or on a date shortly after the date of death. The tax law permits use of this "alternate valuation date" in order to prevent the inequity of imposing the estate tax on the date of death value of property if that value declines shortly after the date of death. The current rule is that the estate may elect to value the property of the decedent as of the date 6 months after the decedent's death instead of at the date of death. Thus, if the decedent's property declines in value during that six month period, the estate tax may be computed on the lower value of the property. This is an eminently fair rule which avoids the harsh result of paying an estate tax based on values which in fact did not exist shortly after the date of death.

However, there is one problem with the existing rule. The alternate valuation date may be used only if it is elected on an estate tax return that is filed within the prescribed time. Thus, even where there is reasonable cause for the failure to file the return within the prescribed time, the alternate valuation date may not be used. Moreover, if the estate tax return is just one day late, and even if the delay is due to reasonable cause, the estate may not use the alternate valuation date.

It is also incongruous that the penalties specifically provided for the late filing of a return do not apply if there is reasonable cause for the late filing, while in such a case the alternate valuation date election is absolutely precluded. Yet, the penalty of the loss of the alternate valuation date may be more severe than the penalty specifically provided for late filing.

The effects of this provision of the Federal estate tax law are illustrated by the case of my Tennessee constituents. In this case, the value of the estate declined severely during the six months following death, yet the alternate valuation date election was denied because, at the time the return was due, the estate's co-executor was recovering from open heart surgery. It was therefore impossible to file a timely return.

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[2] The committee may wish to change the effective date to reflect the passage of time since this legislation was first introduced as S. 3381 in the 95th Congress.

My bill would not change any of the specific penalties for the late filing of a return. It would merely permit an estate to elect the alternate valuation date if, for some reason, the return is not filed on time. I believe that this alternate valuation date is intended to and should apply if the decedent's property has severely decreased in value, even if, for some reason the return is not timely filed.

I understand, Mr. Chairman, that everyone who has looked at this matter, including the Treasury Department, agrees that the harsh result of present law does not serve any legitimate tax policy, and therefore should be changed.

The only question raised is whether the new rule should apply to estates of persons who have already died, or whether it should only apply to future estates.

Mr. Chairman, this Committee has frequently acknowledged that when existing tax law imposes an unfair and unintended result, it should be changed in such a manner as to rectify all those hardship cases which reasonably can be assisted. I believe that this situation calls for that type of response, and I urge you to favorably consider this matter.

STATEMENT OF THE AMERICAN BANKERS ASSOCIATION

The American Bankers Association, a trade association composed of over 13,400 banks, 4,000 of which have fiduciary powers, is pleased to have the opportunity to submit this statement in connection with the hearings held on June 19, 1980 on miscellaneous tax bills. We would like to offer our comments on two legislative proposals under consideration by the subcommittee, the election to use estate tax alternate valuation and an extension of time within which to amend governing instruments of charitable split-interest trusts.

H.R. 4544—ELECTION OF ESTATE TAX ALTERNATE VALUATION

The American Bankers Association (ABA) supports H.R. 4544 which would amend Section 2032 of the Internal Revenue Code to permit an executor of an estate to elect the alternate valuation date for estate assets even though the estate tax return is filed after the due date (nine months after the date of death). Under current law, Section 2032(c) precludes the use of the alternate valuation date if the return is filed late. This is a harsh result which does not further any legitimate policy of the tax laws and in fact unduly penalizes the beneficiaries of a decedent's estate.

The disallowance of the use of the election of alternate valuation by the executor, where the estate tax return is not timely filed, has the result of imposing a triple penalty on the estate and ultimately on the heirs and distributees of that estate. An election of alternate valuation is usually made when a significant decline in the value of the assets of the estate occurs following the decedent's death. When the election of alternate valuation is prohibited the estate is precluded from taking into account the loss in value of the assets for estate tax purposes. Thus, higher estate taxes, based on the value of the property at the date of death, must be paid thereby further reducing the value of property to be distributed to the heirs. In addition, the estate and its beneficiaries are penalized because of the penalties that are imposed for the late filing of an estate tax return.

Lastly, there cannot be any planned tax avoidance "loophole" created by enactment of this legislation because the alternate valuation date is six months after the date of death which is three months before the estate tax return is due. The alternate valuation date election should be available in all situations and the only penalties that should be imposed on the estate are those penalties for late filing.

H.R. 7220—EXTENSION OF TIME TO AMEND INSTRUMENTS OF CHARITABLE SPLIT-INTEREST TRUSTS

In 1969 Congress enacted the Tax Reform Act which imposed new highly technical and complex requirements that must be met in order for a charitable deduction to be allowed on the transfer of a split-interest gift to charity. In 1970, 1972, 1974 and 1978 Congress as well as the Internal Revenue Service provided time extensions and transitional rules allowing these trusts to qualify for the tax deductions if by a specified date the governing instrument was amended to conform to the requirements of the 1969 Act.

The American Bankers Association urges enactment of H.R. 7220 which would extend for an additional two years the time period within which charitable split-interest trusts may be amended and thereby take advantage of the charitable deductions. Although eleven years have elapsed since the imposition of the technical rules governing charitable split-interest trusts, trust instruments are still in existence which would qualify for tax deductions were sufficient time available to amend these instruments.

When Congress passed legislation extending the dates by which governing instruments could be amended if realized that the charitable split-interest trust rules incorporated in the 1969 Tax Reform Act were of such a highly complex and technical nature that additional time was needed in order for the legal profession and trustees to familiarize themselves with the requirements of the law and make the needed reforms in the trust instruments. Because of the transitional rules a sizeable majority of trusts were amended and conformed, thereby qualifying for charitable deductions. Many of those who benefited and will benefit from the extension of time are the charities themselves, upon whom the burden of taxes may fall if the trusts can no longer be reformed to meet the technical requirements and take advantage of the tax deductions. The two year extension provided for in H.R. 7220 should be enacted into law to ensure that those instruments of charitable split-interest trusts which were not timely conformed to the 1969 requirements of the Tax Reform Act can now be amended and qualify for a charitable deduction.

We thank the subcommittee for the opportunity to comment on these proposals which are currently under consideration.

H.R. 4640

A BILL To amend the Internal Revenue Code of 1954 to exempt holdings in independent local newspapers from taxes on excess business holdings of private foundations

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) paragraph (4) of section 4943(d) of the Internal Revenue Code of 1954 (relating to taxes on excess business holdings) is amended—

(1) by striking out "or" at the end of subparagraph (A),

(2) by striking out the period at the end of subparagraph (B) and inserting in lieu thereof ", or", and

(3) by inserting after subparagraph (B) the following new subparagraph:

"(C) an independent local newspaper business (as defined in paragraph (5))."

(b) Subsection (d) of section 4943 of such Code is amended by adding at the end thereof the following new paragraph:

"(5) INDEPENDENT LOCAL NEWSPAPER BUSINESS.—For purposes of paragraph (4)—

"(A) IN GENERAL.—The term 'independent local newspaper business' means—

"(i) a proprietorship which publishes an independent local newspaper;

"(ii) a partnership which publishes an independent local newspaper and which has none of its outstanding partnership interests traded in an established securities market; and

"(iii) a corporation which publishes an independent local newspaper and which has none of its outstanding capital stock traded in an established securities market.

"(B) INDEPENDENT LOCAL NEWSPAPER.—The term 'independent local newspaper' means a newspaper publication which is not one of a chain of newspaper publications and which has all of its publishing offices (containing its principal editorial, reportorial, circulation, and business staff) in a single city, community, or metropolitan area, or, on January 1, 1979, within one State.

"(C) A CHAIN OF NEWSPAPER PUBLICATIONS.—The term 'a chain of newspaper publications' means two or more newspaper publications which are not published in a single city, community, or metropolitan area or, on January 1, 1979, within one State and are controlled, directly or indirectly, by the same person or persons."

(c) The amendments made by this Act shall apply to taxable years ending after the date of the enactment of this Act.

SUMMARY

Present law

The Tax Reform Act of 1969 imposed an excise tax upon the excess business holdings of a private foundation (sec. 4943 of the Code). Generally, under the excess business holdings provisions, the combined ownership of a business by a private foundation and all disqualified persons cannot exceed 20 percent of the voting stock of the business (35 percent if other persons have effective control of the business).

The 1969 Act provided that if a private foundation and disqualified persons together had holdings on May 26, 1969 in excess of the permitted amounts under the general rules, then those holdings could be retained if they consisted of not more than 50 percent of the business. If the combined holdings exceeded 50 percent of the business on that date, then over a transitional period the combine holdings have to be reduced to 50 percent (ultimately to 35 percent if the disqualified persons hold, in the aggregate, no more than 2 percent of the business; if they hold more than 2 percent, then the combined holdings may continue to be as much as 50 percent, of which the foundation itself may hold no more than 25 percent).

Issue

The issue is whether ownership by a private foundation in an independent local newspaper business should be exempted from the excess business holding provision of present law.

Explanation of the bill

The bill provides that an independent local newspaper business would not be treated as a business enterprise for purposes of the excess business holding provisions of the Code (sec. 4943). Thus, there would be no limitation on the percentage interest in such an enterprise that a foundation may own.

An independent local newspaper business means a business (whether organized as a corporation, partnership, or proprietorship), no interests in which are traded in an established securities market, which publishes an independent local newspaper. An "independent local newspaper" is defined as a newspaper publication which is not a member of a chain of newspapers if it has all of its publishing offices in a single city, community or metropolitan area, or, as of January 1, 1979, within one State. A "chain of newspaper publications" is defined as two or more newspaper publications under common control on January 1, 1979, and which are not published in a single city, community, or metropolitan area.

This provision would apply to the Houston Endowment of Houston, Texas, and any other private foundation which also meets the specific requirements of the provision.

Effective date

The bill would apply to taxable years ending after the date of enactment of the bill.

Revenue effect

The revenue estimate for this bill is not yet available.

H.R. 5512

A BILL To amend section 4941(d)(2) of the Internal Revenue Code of 1954 with respect to private foundations

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 4941(d)(2) of the Internal Revenue Code of 1954 is amended by adding the following new subparagraph "(H)".

"(H) the leasing by a disqualified person to a private foundation of office space for use by the foundation in a building in which there are tenants who are not disqualified persons shall not be an act of self-dealing if—

"(i) such leasing of office space is pursuant to a binding lease which was in effect on October 9, 1969, or pursuant to renewals of such a lease;

"(ii) the execution of such lease was not at the time of such execution a prohibited transaction (within the meaning of section 503(b) or the corresponding provisions of prior laws); and

"(iii) the space is made available to the foundation on a basis no less favorable than that on which such space would be made available in an arm's-length transaction."

SEC. 2. This amendment shall be effective on the date of enactment.

SUMMARY

Present law

The 1969 Tax Reform Act in effect prohibited certain "self-dealing" transactions between a private foundation and "disqualified persons" with respect to that foundation. These prohibited transactions include leasing arrangements between a private foundation nad disqualified persons (Code sec. 4941(d)(1)(A)).

The 1969 Act also provided a transitional rule permitting continuation—until taxable years beginning after December 31, 1979—of otherwise prohibited leasing arrangements pursuant to binding contracts in effect on October 9, 1969 (or pursuant to renewals of such contracts). In order to qualify for this 10-year transitional protection, the leasing arrangement must be at least as favorable to the foundation as an arm's-length transaction with an unrelated party (Public Law 91-172, sec. 101(1)(2)(C)).

Issue

The issue is whether a private foundation which has been leasing office space from a disqualified person pursuant to an arrangement protected by the 10-year transitional rule should be able to continue such arrangement thereafter if the space is made available to the foundation on a basis no less favorable than that in an arm's-length transaction and if the leased space is in a building in which there are tenants who are not disqualified persons.

Explanation of the bill

The bill would provide a permanent exception from the self-dealing rules under Code section 4941 in certain circumstances where a private foundation leases office space from a disqualified person, if the lease is pursuant to a binding contract in effect on October 9, 1969 (or renewals thereof) and if at the time of execution the lease was not disadvantageous to the foundation.[1] For the lease to qualify for this exception, the space must be leased to the foundation on a basis no less favorable than that on which such space would be made available in an arm's-length transaction, and the leased space must be in a building in which there are tenants who are not disqualified persons.

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[1] The regulations indicate that present law requires that the leasing transaction must remain throughout the term of the lease as favorable to the foundation as a current arm's-length transaction with an unrelated person (Treas. Regs. § 53.4941(d)-4(c)(1)). Renegotiation of contracts may be required in certain cases (Treas. Regs. § 53.4941(d)-4(c)(2)).

The provision would apply to the Moody Foundation of Galveston, Texas, and any other private foundation which has been leasing space from a disqualified person pursuant to an arrangement covered by the 10-year transitional rule and has a lease meeting the specific requirements of the provision.

Effective date

The bill would be effective on the date of enactment.

Revenue effect

It is estimated that this provision will reduce budget receipts by less than $5 million annually, beginning with fiscal year 1981.

Other congressional action

The Senate Finance Committee has approved an identical provision, which is contained in H.R. 2297 as amended (S. Rept. 96-504).

H.R. 5719

A BILL To amend the Internal Revenue Code of 1954 to clarify the tax exemption of proceeds from certain bingo games

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 513(f) of the Internal Revenue Code of 1954 is amended by striking the period at the end of subsection (2)(c) thereof, and by inserting in lieu thereof the following: "(but only if such State or local law is generally enforced)."

SEC. 2. The amendment made by the first section of this Act shall be effective for taxable years beginning after December 31, 1969.

SUMMARY

Present law

Most organizations which are generally exempt from Federal income tax, such as charitable or educational organizations described in Code section 501(c)(3), remain subject to tax on any "unrelated business taxable income," defined as gross income derived from any "unrelated trade or business" (Code secs. 511–512). In Public Law 95–502, the Congress provided that the term "unrelated trade or business" does not include any trade or business which consists of conducting certain bingo games (Code sec. 513(f)). This provision was effective for taxable years beginning after December 31, 1969 (the effective date for extension to most exempt organizations of the tax on unrelated business taxable income).

Also in Public Law 95–502, the Congress provided that political organizations are not subject to tax on income from bingo games proceeds from which would not be taxable if received by exempt organizations (Code sec. 527(c)(3)(D)). This provision was generally effective for taxable years beginning after December 31, 1974 (the effective date of Code sec. 527, which provides rules for the taxation of political organizations).

In the case of both tax-exempt and political organizations, the rules added by Public Law 95–502 apply only if (among other requirements) the conducting of the bingo game "does not violate any State or local law" (Code sec. 513(f)(2)(C)). In House Report 95–1608 on these bingo game provisions, the Ways and Means Committee stated that "this limitation is designed to ensure that no Federal tax benefit is provided for activities which are conducted illegally."

The Treasury Department has issued final regulations under the bingo game rules added by Public Law 95–502, which incorporate the statutory limitation that favored tax treatment is not available in the case of bingo games conducted in violation of State or local law (Treas. Reg. § 1.513–5(c)(1)). The statement of "supplemental information" published with the final regulations states that the Internal Revenue Service had received comments, in response to issuance of such regulations in proposed form, suggesting that a bingo game should not be considered to violate State or local law if a statute or ordinance prohibiting such games nonetheless is not generally enforced against tax-exempt organizations (45 Fed. Reg. 33969, May 21, 1980). The Treasury statement declares that "it would not be appropriate for the Internal Revenue Service to independently determine that a statute proscribing gambling is, nevertheless, not the law of the State." The statement also refers to the legislative history cited above.

Issue

The issue is whether proceeds derived from bingo games should be exempted from income tax in the case of charitable, etc. or political organizations if the State or local statute or ordinance making such games illegal is not "generally enforced."

Explanation of the bill

The bill would provide that proceeds derived from bingo games are exempt from income tax in the case of charitable, etc. or political organizations if the State or local statute or ordinance making such games illegal is not "generally enforced."

Effective date

The bill would be effective for taxable years beginning after December 31, 1969.

Revenue effect

It is estimated that this bill will reduce budget receipts by less than $5 million annually.

H.R. 5847

A BILL Relating to the application of section 103(b) of the Internal Revenue Code of 1954 to certain bonds for harbor improvements

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) for purposes of section 103(b) of the Internal Revenue Code of 1954 (relating to industrial development bonds), the use of the proceeds of any issue of obligations which meets the requirements of subsection (b) to acquire and improve existing wharf facilities shall be treated as a use which meets the requirements of paragraph (4)(D) of such section 103(b) (without regard to whether the person from whom the facilities were acquired, or a related person, is a substantial user of such facilities before and after the issuance of such obligations).

(b) For purposes of subsection (a), an issue of obligations meets the requirements of this subsection if—

(1) part of the proceeds of such issue are to be used to make substantial improvements in the existing wharf facilities to be acquired with such proceeds,

(2) there is reasonably expected to be more than one substantial user of such existing wharf facilities after the issuance of such obligations,

(3) at least one of the substantial users of such existing wharf facilities after the issuance of such obligations was not a substantial user of such facilities before the issuance of such obligation (and was not a related person to such a user),

(4) all facilities with respect to which financing is provided from the proceeds of such issue are to be owned by the issuer,

(5) the only interest in such facilities to be held by any substantial user of such facilities (or related person) is to be a lease executed after the issuance of such obligations—

(A) which is for a period (including options to renew) of not more than eighty years, and

(B) under which no lessee has an option to purchase, and

(6) section 101 of Public Law 91-611 authorized the initiation and partial accomplishment of a project (described in House Document Numbered 91-401) deepening the channel for the port in which such facilities are located.

(c) For purposes of this section—

(1) The term "existing wharf facilities means any docks, wharves, or storage or training facilities directly related to any docks or wharves, the original use of which began before the issuance of the obligations.

(2) The terms "substantial user" and "related person" have the same meaning as when used in section 103(b) of the Internal Revenue Code of 1954.

SUMMARY

Present law

Under present law, interest on State and local government obligations is generally exempt from Federal income tax. However, since 1968, tax exemption has been denied to State and local government issues of industrial development bonds (IDBs). A State or local government bond is an IDB if (1) all or a major portion of the proceeds of the issue are to be used in any trade or business of a person other than a State or local government or tax-exempt organization, and (2) payment of principal or interest is secured by an interest in, or derived from payments with respect to, property or borrowed money used in a trade or business.

An exception to the denial of tax exemption for the interest on an IDB applies in the case of such obligations which are used to provide exempt activity facilities, including docks and wharves (Code sec. 103(b)(4)(D)). This exception applies where the proceeds of an IDB are to be used to finance the construction of a new facility or to finance the acquisition of an existing facility from an unrelated person. However, under the IRS regulations, tax exempt IDBs cannot be issued where the proceeds of an IDB are to be used to refinance an existing facility which was not originally financed with tax-exempt bonds (e.g., it was conventionally financed). Under these IRS regulations, tax exempt IDBs can be issued for the financing of an existing facility only where a person who was a substantial user of the facilities before issuance of the obligations and who receives a certain portion of the proceeds of the obligation will not be a substantial user of the facilities following the issuance of the obligations (Treas. Reg. sec. 1.103–8(a)(5)(iv)). In general, a substantial user of a facility includes any nonexempt person who regularly uses a part of such facility in his trade or business where (1) the gross revenue derived by such user with respect to such facility is more than 5 percent of the total revenue derived by all users of such facility or (2) the amount of area of the facility occupied by such user is more than 5 percent of the entire usable area of the facility (Treas. Reg. sec. 1.103–11(b)). For example, the interest on an IDB would not be tax exempt in the case where the proceeds of the obligation are used by a governmental entity to purchase docks and wharves which are then, in turn, leased back to the prior owner for a period equal to the useful life of the docks and wharves.

Issue

The issue is whether tax-exempt IDBs should be allowed to be used to refinance certain existing conventionally financed docks and wharves located in Tampa, Florida.

Explanation of the bill

The bill provides that interest on certain IDBs used to refinance existing conventionally financed docks and wharves in Tampa, Florida, would be exempt from Federal income taxation. In order to qualify under this provision, six requirements must be satisfied. First, part of the proceeds of the obligations must be used to make substantial improvements in the existing wharf facilities acquired with the obligations. Second, it must reasonably be expected that there will be more than one person who will be a substantial user of the facilities after the issuance of the obligations. Third, at least one of the substantial users of the existing wharf facility after the issuance of the obligations must not have been a substantial user before the issuance of the obligation. Fourth, all facilities with respect to which financing is provided must be owned by the issuing governmental unit. Fifth, the only interest in such facilities to be held by a substantial user must be a lease executed after issuance of the obligations for a period (including options) of not more than 80 years and under which no lessee has an option to purchase the facilities. Finally, the facilities must be located in a port with respect to which section 101 of Public Law 91–611 authorized the initiation and partial accomplishment of a project as described in House Document No. 91–401.[1]

The principal beneficiary of this bill would be the Agrico Chemical Company.

Effective date

The bill would be effective for obligations issued after the date of enactment.

Revenue effect

It is estimated that this bill would reduce budget receipts by $1 million in fiscal year 1981, $2 million in 1982, and $3 million in 1983, 1984 and 1985.

STATEMENT OF HON. RICHARD STONE, A U.S. SENATOR FROM THE STATE OF FLORIDA

I appreciate having this opportunity to submit testimony on H.R. 5847, introduced by Congressman Gibbons, which will enable the Tampa Port Authority to use tax-exempt industrial development bonds to expand and improve the Port of Tampa. This legislation is the companion bill to legislation, S. 2548, that I have introduced in the Senate.

The Port of Tampa is the nation's seventh largest port, with a net tonnage of 49,830,441 tons in 1979. Over half that tonnage consists of phosphate products. In order to handle these shipments in a more timely and efficient manner the

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[1] This document describes only the Port of Tampa, Fla.

Port Authority is seeking to acquire and expand an existing phosphate terminal for lease-back to a joint venture group, which includes the previous owner. The Port is prohibited by Treasury regulations from using tax-exempt industrial development bonds for this purpose because of the previous owner's inclusion in this joint venture company. My legislation would amend the substantial user rules for industrial development bonds used in this expansion by the Tampa Port. This expansion will produce substantial economic benefits for the state and local community, and will result in a revenue gain to the federal government through the elimination of demurrage charges and a tax gain on the increased business.

H.R. 6935

A BILL To exempt from Federal income tax certain subsistence allowances received by State police officers before January 1, 1978

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled. That (a) subsection (b) of section 3 of the Act of October 7, 1978, entitled "An Act to prohibit the issuance of regulations on the taxation of fringe benefits, and for other purposes", is amended to read as follows:

"(b) ALLOWANCES TO WHICH SECTION APPLIES.—For purposes of this section, this section applies to any statutory subsistence allowance or subsistence allowance negotiated in accordance with State law which was received after December 31, 1969, and before January 1, 1978."

(b) In the case of any allowance to which such section 3 applies by reason of the amendment made by subsection (a) of this Act, subsections (a)(2) and (e) of such section 3 shall be applied by substituting the date one year after the date of the enactment of this Act for "April 15, 1979 "each place it appears.

H.R. 6953

A BILL To amend Public Law 95–427 to permit certain State police officers to file a claim for credit or refund of Federal income tax with respect to certain subsistence allowances, without regard to whether the allowance was included in gross income

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) subsection (b) of section 3 of Public Law 95–427 is amended to read as follows:

"(b) ALLOWANCES TO WHICH SECTION APPLIES.—For purposes of this section, this section applies to any statutory subsistence allowance or subsistence allowance negotiated in accordance with State law which was received after December 31, 1969, and before January 1, 1978."

(b) Subsection (c) of such section is amended to read as follows:

"(c) STATE POLICE OFFICER DEFINED.—For purposes of this section, the term 'State police officer' means any police officer (including a highway patrolman) employed by a State (or the District of Columbia) on a full-time basis with the power to arrest."

(c) If refund or credit of any overpayment of tax resulting from the application of the amendments made by this Act is prevented at any time during the one-year period beginning on the date of the enactment of this Act by the operation of any law or rule of law (including res judicata), refund or credit of such overpayment (to the extent attributable to the application of the amendments made by this Act) may, nevertheless, be made or allowed if claim therefor is filed during such one-year period. The preceding sentence shall not apply to an overpayment attributable to an allowance received during the calendar year 1977.

SUMMARY

Present law

Code section 119, which was enacted in 1954, excludes from an employee's gross income the value of employer-furnished meals if they are provided for the employer's convenience, on its business premises, and for substantially noncompensatory reasons. The legislative history of section 119 indicates that the exclusion applies only to the value of meals furnished in kind.[1]

Although in 1954 Congress provided for an exclusion of up to $5.00 per day of statutory subsistence allowances paid to police officers, this provision was repealed in 1958 "to bring the tax treatment of subsistence allowances for police officials into line with the treatment of such allowances in the case of other taxpayers. * * *"[2]

On November 29, 1977, the Supreme Court decided *Commissioner* v. *Kowalski*, 434 U.S. 77, which held that cash meal allowances paid to a state trooper were includible in income since the section 119 exclusion applied only to meals furnished in kind. This decision resolved a conflict between the various appellate courts as to the taxability of cash meal allowances.

In response to the *Kowalski* decision, Congress enacted section 3 of Public Law 95–427. Under that section, the Supreme Court's decision generally applies only prospectively. The Act allowed an exclusion from gross income for certain subsistence allowances received by an officer during the years 1970 through 1976 to the extent that the allowances were not included in income on the officer's income tax return. It also applied to all of these subsistence allowances received in 1977 without regard to an officer's treatment of those allowances on his or her return.

Public Law 95–427 did not authorize the refund of taxes paid prior to 1977 on such cash allowances if those payments had been included in income on the officer's income tax return. Thus, the Act was restricted to cases where officers might experience hardships in paying income tax deficiencies assessed with respect to cash meal allowances.

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[1] S. Rept. No. 1622, 83d Cong., 2d sess. 190–191 (1954).

[2] H.R. Rept. No. 775, 85th Cong., 1st sess. 7 (1957), 1958–3 C.B. 817.

Issue

The issue is whether taxes paid with respect to cash meal allowances received by State police officers during 1970 through 1976 should be refunded where the allowances were reported as income.

Explanation of the bill

The bills would allow a refund or credit of tax paid by a State police officer with respect to a cash meal allowance (within the meaning of section 3 of Public Law 95–427) received between 1969 and 1977 regardless of whether those cash payments were reported in gross income.

Effective date

The bills would be effective upon enactment. The period of limitations for making refunds would not operate to bar any claim for refund filed within one year of the date of enactment of the bill.

Revenue effect

It is estimated that either bill will result in a one-time decrease in budget receipts of $5 million in fiscal year 1981. This represents refunds or credits for tax paid by State police officers with respect to cash meal allowances during 1970 through 1976 where the allowances were reported in income.

Prior congressional consideration

During the 95th Congress, the Subcommittee on Taxation and Debt Management Generally of the Senate Committee on Finance conducted hearings on S. 2872. That bill included amendments which were substantially similar to the provisions of H.R. 6953. The Finance Committee did not report those amendments.

STATEMENT OF HON. MILLICENT FENWICK, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW JERSEY

Mr. Chairman, I'd like to express my gratitude for this opportunity to comment on H.R. 6935, which will allow a tax exemption for state troopers' subsistence allowances which were received before January 1, 1980.

I think we all realize the circumstances surrounding this legislation: while the issue of taxing allowances was being decided in court, many New Jersey state troopers complied with procedures established by the Internal Revenue Service's Newark District Office. These procedures required that the state troopers include the subsistence allowance as income, on which they paid tax. Since that time, Congress passed Public Law 95–427 in an effort to provide these troopers with refunds on the taxes they paid on their subsistence allowances.

Now, because of a dispute in interpretation of this law, many of those troopers who had followed the IRS's directions will not be able to receive reimbursement and, in a further ironic twist, the troopers who chose not to include subsistence allowance as taxable income have been able to avoid this confusing situation altogether.

It is easy for us to point fingers at the IRS, claiming they have ignored the intent of Congress in their interpretation of this statute. It is just as easy for that agency to accuse Congress of writing the law poorly. The point is that this new law is not a controversial matter—we overwhelmingly passed Public Law 94–427. This new legislation, H.R. 6935, merely has the effect of clarifying our intentions. The entire New Jersey delegation supports the bill, as does the Treasury Department.

It is only just and fair that we pass this legislation as quickly as possible. The state troopers have complied with IRS directives in good faith and now the government is in the indefensible position of failing to honor its promise. Those state troopers who were taxed on their subsistence allowances should have this tax refunded. Both Congress and the IRS should work together to refund to the troopers the money to which they are entitled. I urge prompt and favorable action on H.R. 6935.

Thank you, Mr. Chairman.

STATEMENT OF HON. JAMES J. FLORIO, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW JERSEY

Mr. Chairman, members of the Subcommittee, I urge your prompt approval of legislation, H.R. 6935, on this morning's hearing agenda. Sponsored by the entire New Jersey Delegation, this legislation is designed to provide equity in the continuing dispute between the Internal Revenue Service and the N.J. State Police concerning the taxation of police subsistence allowances.

Public Law 95–427, enacted by the Congress in 1978, has largely solved the problem of retroactive taxation of police subsistence allowances. This problem resulted from the Internal Revenue Service's retroactive application of the Supreme Court's 1977 "Kowalski" decision, making taxable under gross income the meal allowances paid to state troopers while on duty. Retroactive application of the "Kowalski" decision resulted in over 2300 N.J. Troopers and troopers in 15 other states liable for large back tax assessments, ranging as much as four to seven thousand dollars in individual cases.

The 1977 Supreme Court "Kowalski" decision reversed 23 years of largely consistent judicial opinion that meal allowances paid to state police are not taxable. Until the 1977 Supreme Court ruling, N.J. State Troopers were supported by decisions made by the U.S. Court of Appeals for the Third District, that their meal allowances were non-taxable. Retroactive application of "Kowalski" would have been unfair and a crushing financial burden on thousands of police officers and their families.

The Congress appropriately recognized these concerns and approved legislation in 1978 applying the Supreme Court's "Kowalski" decision to state police officers on a prospective basis only.

The report filed by the Ways and Means Committee in May 1978 was clear in the purpose of the legislation. It stated "that the decision of the Supreme Court in the 'Kowalski' case should not be applied to statutory subsistence allowances received prior to 1978".

Congress approved the 1978 legislation with the intent to stop the I.R.S. from seeking retroactive taxation of the meal allowance, and in order to promote equity, reimburse those troopers who reported their meal allowance and paid tax on it during 1971 to 1977.

The I.R.S. now maintains that the 1978 statutory language is not sufficient to permit them to reimburse N.J. State Troopers who paid taxes on their meal allowances for the years 1974, 1975 and 1976, and who claimed no offsetting deductions.

This adverse I.R.S. interpretation of Public Law 95–427, has resulted in a unique situation. N.J. State Troopers who paid no Federal tax on their meal allowances during 1970 to 1977 are completely exempt from back taxes under the 1978 law. Similarly, any officer who reported the meal allowance in their tax form, and claimed offsetting deductions, can receive appropriate reimbursement under the 1978 law. But those officers who followed I.R.S. instructions and paid taxes on their meal allowances, and claimed no offsetting deduction, have been ruled by the I.R.S. as ineligible to receive full tax reimbursements under the 1978 law.

By denying full tax reimbursement to these officers, the I.R.S. has violated the spirit of the 1978 law and has created a large inequity in the law's administration.

Between 150 and 200 State police officers in New Jersey are being denied full reimbursement for previous taxes paid on their meal allowances. I understand that the revenues involved total around $270,000. Because of the administrative complexities involved in this issue, only troopers from N.J. are being denied full reimbursement under the 1978 law. Troopers from all other affected states have been provided relief under the 1978 statute. The large majority of N.J. troopers have experienced no difficulties in receiving proper tax reimbursements, or in having their tax liabilities for previous years rescinded.

The 1978 law has worked well in the large majority of cases. The Congress would be in error, however, if it did not act to correct the inequity that exists in the law's administration by insuring that all eligible troopers receive their full tax reimbursement.

The legislation before the Committee provides this insurance and fulfills the intention of the Congress in approving the 1978 statute. I again urge the Committee to promptly approve this measure so that the 1978 law can be fairly administered in all cases.

Thank you.

Statement of Edwin B. Forsythe, a Representative in Congress From the State of New Jersey

Mr. Chairman, it is a pleasure to have this opportunity to express my support for H.R. 6935 at this hearing conducted by the House Ways and Means Subcommittee on Select Revenue Measures.

As many of you know, I, along with the rest of the New Jersey delegation, am a cosponsor of H.R. 6935 which is designed to clarify the original intent of Congress in Public Law 95–427. This law, passed overwhelmingly by the Congress in October of 1978, was supposed to allow a state trooper to file for retroactive tax exemptions for subsistence allowances of preceding years. Previous to this action, the Supreme Court ruled that the allowances should count as income under the law, and are, therefore, taxable.

Unfortunately, the Internal Revenue Service has not interpreted Public Law 95–427 in the way that Congress intended. There has been a great deal of conflict between the New Jersey State Police, as well as 12 other state police organizations, and the I.R.S. concerning the way in which the exemption is to be applied for by the troopers. The I.R.S. has also given instructions to individual troopers which have resulted in making them ineligible. To clarify and codify our original intent in Public Law 95–427 I strongly support the passage of H.R. 6935 and urge my colleagues to do the same.

Thank you for this opportunity. I am hopeful that we can finish consideration and win final approval of H.R. 6935 by the end of the 96th Congress.

Statement of Hon. William J. Hughes, a Representative in Congress From the State of New Jersey

Mr. Chairman and Members of the Subcommittee on Select Revenue Measures, I appreciate having this opportunity to testify in support of important remedial legislation. This legislation would do away with the administrative fiasco resulting from the Internal Revenue Service's misinterpretation of the 1978 law relating to the tax treatment of the subsistence allowances of state troopers.

As you may recall, in November, 1977, the Supreme Court ruled, in *Commissioner of Internal Revenue* v. *Kowalski*, that the meal allowances of state troopers were to be subject to federal taxation.

While the case was pending before the courts, IRS district offices were instructing state troopers to include their meal allowances in their taxable income, and encouraging them to file Form 872, which keeps the statutory period for assessment of taxes open, in order to simplify the refund process in the event that the Court decided in favor of Kowalski.

Unfortunately, certain police officers in 14 states ignored the IRS directive, and did not pay taxes on their allowances. When the Supreme Court handed down its decision, these troopers were immediately liable for these back taxes, some owing the IRS as much as $5,000. Naturally, this posed a severe hardship for those who had relatively modest incomes.

Recognizing the problem, Congress acted swiftly and approved Public Law 95–427, which voided the tax liabilities that resulted from the *Kowalski* decision. Since the tax obligation was to be prospective only, state troopers would only be asked to pay taxes on their meal allowances after tax year 1977.

It now appears that the IRS has ignored the intent of Congress, and has interpreted the 1978 law so narrowly that the agency completely missed the target. The guidelines established in Revenue Procedure 79–13 do relieve troopers who failed to pay taxes on this allowance from 1970 through 1977 of this obligation. The problem is that the IRS has not established a procedure which will uniformly reimburse those state troopers who paid taxes on their benefits for all the taxes that they paid.

Several hundred New Jersey state troopers now find themselves ineligible for refunds on the taxes they paid between 1974 and 1976, precisely because they complied with IRS directives at that time. Only those who followed the letter of the law are now being penalized.

The IRS's interpretation of Public Law 95–427 not only ignores the intent of Congress, but violates our sensibilities. Why should anyone obey the law if they will only be discriminated against later for their conscientious efforts. Revenue Procedure 79–13 contradicts everything we've ever learned about justice and fair play, and must not remain intact.

It is essential that we provide law-abiding state troopers with a chance to qualify for refunds on the taxes they paid on their subsistence allowances in 1974, 1975, and 1976. We must make clear to the Internal Revenue Service that Congress intended the *Kowalski* decision to be prospective only, and that Public Law 95-427 was to apply to all state troopers involved, both those who paid taxes on their meal allowances, and those who did not.

Mr. Chairman, I urge you and the Members of the Subcommittee to move expeditiously to approve legislation which will address this problem, so that we can send a clear message to the IRS. Thank you for providing me with the opportunity to testify on behalf of this legislation.

Statement of Hon. Peter W. Rodino, Jr., a Representative in Congress From the State of New Jersey

Mr. Chairman, I am grateful for the opportunity to address the distinguished members of the Subcommittee on Select Revenue Measures of the House Ways and Means Committee as you consider legislation to grant a meal allowance tax-exemption to New Jersey State Troopers for the years 1974 through 1976.

The complicated history of this issue bears recounting. Until 1949, New Jersey State Toopers ate meals free at their headquarters. The Internal Revenue Service did not treat those meals as taxable income. As the state's population and road system expanded, so did the range and the responsibilities of the troopers. They frequently found themselves on the road at mealtimes, and the State of New Jersey furnished them a meal allowance.

The IRS considered this cash allowance as taxable income, not as meals-in-kind. However, in *Saunders* v. *Commissioner of Internal Revenue* (1954), the U.S. Court of Appeals for the Third Circuit upheld the tax-exempt status of the meal allowance.

The situation remained unchanged until 1970, when the IRS audited the return of Trooper Robert J. Kowalski, again counting a meal allowance as taxable income. Kowalski challenged the decision in a court battle that spanned nearly the whole decade.

During the six years the case progressed through the courts the New Jersey Regional Office of the IRS instructed our State Troopers to pay tax on their meal allowance and file the No. 872 Form to extend the three year statute of limitations on their tax return, thus permitting troopers to amend their income tax statements if the courts ruled in their favor.

Troopers responded to the instructions in four different ways. Some followed the IRS directive by including the allowance in their taxable income and paying taxes on the allowance. Others counted the allowance as income but claimed the meals as a business expense. The third group did not file the allowance as income. A fourth group was audited and ordered to include the allowance in their tax statements.

When the Supreme Court ruled on November 29, 1977, great protest from affected parties across the nation followed. The decision made troopers liable for up to $5,000 in back taxes—a burden they could ill afford. A strong sense of justice moved many Members of Congress to redress this hardship. The Ways and Means Committee favorably reported and the Congress passed legislation which prevented retroactive application of the ruling and reimbursed those who had paid the tax. On October 7, 1978 the President signed Public Law 95-427.

Unfortunately for the New Jersey State Troopers, technicalities arose. The law stipulates that only those who filed an amended return could be reimbursed. But the New Jersey Regional Office of the IRS told the troopers to file the No. 872 Time Extension Form—not the 1040X Amending Form. The law retroactively cleared all troopers, including those who never claimed the allowance as income, of liability. But the troopers who declared the allowance, paid a tax on it and did not claim offsetting deductions, in accordance with IRS instructions, could not be reimbursed. In effect, those who obeyed the law and the administrative directives of the IRS are the only persons so far unable to receive relief.

The New Jersey Regional Office of the IRS realized the plight of the troopers and ruled that the No. 872 Form the troopers filed for 1971, 1972 and 1973 could serve as an unofficial amended form. The troopers were reimbursed for the taxes paid on their meal allowance for those years. But since they had not filed extension forms for 1974, 1975 and 1976 the IRS could not refund their tax dollars. The proposed legislation seeks to correct this problem.

Mr. Chairman, many New Jersey State Troopers are being penalized for following the instructions of the Internal Revenue Service. Fairness demands the full and speedy return of their tax dollars.

I urge this committee to report favorably to the House on this much needed legislation. New Jersey public servants who observe the laws and abide by IRS directives deserve protection from administrative mishaps.

Thank you, Mr. Chairman.

STATEMENT OF HON. ROBERT A. ROE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW JERSEY

Mr. Chairman, I appear before this panel today to ask its approval of legislation, H.R. 7149, I have introduced that would put an end to the ongoing tax dispute between the Internal Revenue Service and the New Jersey State trooper organization.

Perhaps a brief history of the situation will clarify why this legislation is so badly needed.

The state of New Jersey has provided meal allowances to state troopers since 1949. The IRS made an early challenge to the troopers excluding the meal allowances from their declared income, but the exclusion was upheld in federal court.

Nearly 20 years later, the IRS made another attempt to halt the meal allowance exclusion in an audit of Trooper Robert J. Kowalski's 1970 income tax return. In that action, the IRS disallowed any exclusion of the meal allowance and any deduction for meal expenses. Kowalski, in return, filed a petition in the U.S. Tax Court disputing the IRS claim. Kowalski went on to win a series of court fights against the IRS.

In February, 1977, the IRS requested the Supreme Court to review the case. In November of that year, the Court handed down a decision reversing the earlier court actions by declaring that the meal allowances were indeed taxable income.

The effect of that decision on an estimated 2,300 New Jersey state troopers and law enforcement officers in 14 other states was disastrous. Immediately they became responsible for paying the IRS up to $5,000 each in back taxes. Most of the law enforcement officers could ill afford the tax payment and those who had retired would have been forced to pay the IRS from their pensions.

Through the efforts of the New Jersey congressional delegation legislation was passed by Congress and signed by President Carter that overturned the Supreme Court decision. The law banned the IRS from tax reprisals against the troopers who failed to include meal allowances as incomes and ordered it to reimburse the troopers who paid tax on the allowances during the years 1971–1977.

While the celebrated Kowalski case was being battled in the courts and Congress, the Newark District IRS office never instructed the state troopers to file a form which would allow a later amendment of their tax returns.

That action brings us to the current situation. The troopers who claimed the deduction against the wishes of the IRS now get to keep their money while those who tried to cooperate are being denied their rightful refunds for the years 1974 to 1976.

H.R. 7149 would rectify that situation and put an end to the IRS-State trooper matter. The Treasury Department, acknowledging the screw-up by the Newark IRS office, has agreed in writing not to oppose my legislation which would allow the remaining troopers their refunds for the years in question. The measure amends Public Law 95–427 to permit certain State Police Officers to file a claim for a refund or credit of Federal income tax with respect to certain subsistence allowances without regard to whether or not the allowance was included in gross income.

I urge the subcommittee to give swift approval to this proposal.

H.R. 7220

A BILL To amend the Internal Revenue Code of 1954 to extend for two years the period during which governing instruments may be amended to meet the requirements for a gift of a split interest to charity

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. AMENDMENT OF GOVERNING INSTRUMENTS TO MEET REQUIREMENTS FOR GIFT OF SPLIT INTEREST TO CHARITY

(a) CHARITABLE LEAD TRUSTS AND CHARITABLE REMAINDER TRUSTS IN THE CASE OF ESTATE TAXES.—The first sentence of paragraph (3) of section 2055(e) of the Internal Revenue Code of 1954 (relating to disallowance of deductions in certain cases) is amended by striking out "December 31, 1978" each place it appears and inserting in lieu thereof "December 31, 1980".

(b) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendment made by subsection (a) shall apply in the case of decedents dying after December 31, 1969.

(2) CHARITABLE LEAD TRUSTS AND CHARITABLE REMAINDER TRUSTS IN THE CASE OF INCOME AND GIFT TAXES.—Section 514(b) of the Revenue Act of 1978 shall be applied as if the amendment made by subsection (a) had been included in the amendment made by section 514(a) of such Act.

SUMMARY

Present law

The Tax Reform Act of 1969 imposed new requirements that must be met in order for a charitable deduction to be allowed for income, gift, and estate tax purposes for the transfer of a split interest to charity (i.e., part charitable and part noncharitable). In the case of a remainder interest in trust, the interest passing to charity must be in either a charitable remainder annuity trust, a charitable remainder unitrust, or a pooled income fund. In the case of an "income" interest passing to charity (i.e., a charitable lead trust), the "income" interest must be either a guaranteed annuity or a fixed percentage of the fair market value of the trust (determined annually). These rules generally apply for estate and gift tax purposes, in the case of decedents dying, or transfers made, after December 31, 1969, and for income tax purposes to contributions and transfers in trust after July 31, 1969. However, certain exceptions were provided in the case of wills executed, or property transferred in trust, on or before October 9, 1969. In general, these exceptions did not apply the new rules to these wills and revocable trusts until October 9, 1972 (unless the will was modified in the meantime), to allow a reasonable period of time to take the new rules into account.

In 1970, the Internal Revenue Service issued proposed regulations with respect to the new requirement for a charitable remainder annuity trust or unitrust (under sec. 664 of the Code). These regulations provided additional transitional rules allowing trusts created after July 31, 1969 (which did not come within the statutory exceptions) to qualify for an income, estate, or gift tax deduction if the governing instrument was amended prior to January 1, 1971. Subsequently, the date by which the governing instrument had to be amended was further extended by the Internal Revenue Service. On August 22, 1972, the Internal Revenue Service issued final regulations which further extended the date to December 31, 1972. On September 5, 1972, the Internal Revenue Service published Rev. Rul. 72-395, 1972-2 C.B. 340, which provided sample provisions for inclusion in the governing instrument of a charitable remainder trust that could be used to satisfy the requirement under section 664.

In 1974, Congress extended the date by which the governing instrument of a trust created after July 31, 1969, and before September 21, 1974, or pursuant to a will executed before September 21, 1974, could be amended (P.L. 93–483). Under that Act, if the governing instrument was amended to conform by December 31, 1975, to meet the requirements of a charitable remainder annuity trust or unitrust or pooled income fund, an estate tax deduction was allowed for the charitable remainder interest which passed in trust from the decedent even though the interest failed to qualify at the time of the decedent's death.

The Tax Reform Act of 1976 extended to December 31, 1977, the date by which the governing instrument of a charitable remainder trust created after July 31, 1969 and before December 31, 1977, must be amended in order to qualify as a charitable remainder annuity or unitrust or pooled income fund for purposes of the estate tax deduction. The Act also extended the date in the case of a trust created after July 31, 1969, pursuant to a will executed before December 31, 1977.

In the Revenue Act of 1978, Congress extended the amendment procedure to instruments establishing charitable lead trusts, and charitable remainder trusts in the case of income and gift taxes, which were created before December 31, 1977 (or created pursuant to a will executed before such date) which were amended (or judicial proceedings to amend were commenced) by December 31, 1978. As part of that provision, the Act extended until December 31, 1978, the time to amend (or to commence judicial proceedings to amend) instruments establishing charitable remainder trusts which were created before December 31, 1977 (or created pursuant to a will executed before such date) in order to conform such instruments to the requirements of the Tax Reform Act of 1969 for a charitable deduction to be allowed for estate tax purposes.

Issue

The issue is whether an additional two years should be granted (until December 31, 1980) to amend the governing instruments of charitable split interest trusts which were executed before 1978 in order to conform them to the requirements of the Tax Reform Act of 1969 for a charitable deduction to be allowed for income, gift, or estate tax purposes.

Explanation of the bill

The bill would extend for 2 years (i.e., until December 31, 1980) the time to amend (or commence judicial proceedings to amend) instruments of both charitable lead trusts and charitable remainder trusts which were created before December 31, 1977 (or which were created pursuant to a will executed before such date) in order to conform such instruments to the requirements of the Tax Reform Act of 1969 for a charitable deduction to be allowed for income, gift, or estate tax purposes.

Effective date

The bill would be effective, for estate and gift tax purposes, for decedents dying and transfers after December 31, 1969, and, for income tax purposes, for contributions and transfers in trust after July 31, 1969.

Revenue effect

It is estimated that the bill will decrease budget receipts by $8 million in fiscal year 1980, by $8 milllion in fiscal year 1981, and will not have any revenue effect therafter.

Other congressional action

The Senate Finance Commitee has approved an identical provision, which is contained in H.R. 2492 as amended (S. Rept. 96–532).

STATEMENT OF MILTON S. BARTHOLOMEW, ESQ., ON BEHALF OF EXECUTORS OF THE ESTATE OF IRENE FENTON, DECEASED

Irene Fenton died December 2, 1978, and her will was admited to Probate in January, 1979. In her will, Mrs. Fenton created a trust with 80 percent of the remainder interest going to qualified charitable organizations upon the death of certain named income beneficiaries, and the remaining 20 percent going to a second trust for the lifetime benefit of another named beneficiary upon whose death the entire remainder goes to the same qualified charitable organizations that are to receive the 80 percent upon termination of the original trust. It was the obvious intention of Mrs. Fenton to create charitable remainder trusts qualified for tax deductions under Section 664 of the I.R.C.

This intent was manifested by the following language in her will:

> It is my intention that this trust shall comply with the governing instrument requirement of Section 664 of the Internal Revenue Code and regulations adopted pursuant to such section.
>
> It is my intention to create a charitable remainder unitrust within the purview of Section 664 of the Internal Revenue Code and regulations adopted pursuant to such section. It is my intention that the provisions of this trust and any direction, responsibility, duty or power provided under this trust or inherent under any law of trust now existing or hereinafter enacted be interpreted, construed or applied in such a manner that the charitable remainder created by this trust shall qualify as a charitable remainder unitrust within the purview of the applicable sections of the Internal Revenue Code and regulations adopted thereunder, or any similar statute or regulations later enacted.

Nonetheless, the I.R.S. has ruled that the Fenton will does not create a qualified charitable remainder unitrust for a very technical reason, notwithstanding that the ultimate beneficiaries are qualified charitable organizations, and otherwise meets the requirements of a charitable remainder unitrust. The I.R.S. view is a result of its strict application of the technical requirements of Section 664 and the Regulations promulgated thereunder to the detriment of the qualified charitable organizations which Congress intended to benefit.

In the Fenton will, the I.R.S. has determined that the original trust created by Mrs. Fenton fails to meet these technical requirements for the reason that upon its termination only 80 percent (rather than 100 percent) of its then assets go to qualified charitable organizations at that time, with the remaining 20 percent going to another trust for an additional life span and then is ultimately distributed to the same qualified charitable organizations. Had the original trust provided that the trustee, at the time of the distribution of 80 percent of the trust assets, simply retain the remaining 20 percent in the same trust for ultimate later distribution to the qualified charitable organizations, the trust would have qualified as a charitable remainder unitrust. Moreover, if there had been two trusts initially, one containing 80 percent of the assets and the other 20 percent of the assets, both trusts would have qualified. There is absolutely no difference in substance between either of these situations and the Fention situation. The only difference is that the Fenton language does not strictly comply with the technical language of Section 664 and Regulations as interpreted by the Internal Revenue Service.

The Fenton will is only an illustration of the strict stance taken by the I.R.S. in determining compliance with the highly technical and complicated requirements of I.R.C. Sec. 664 and the Regulations promulgated thereunder. Other examples can be seen by examining various published and private rulings of the Service.

When the Tax Reform Act of 1969 was passed, it represented a sharp departure from the old law relating to charitable remainder trusts. The I.R.S. itself recognized the difficulty of compliance with the new law and adopted Regulations permitting conformity through retroactive amendments following the death of the creator of the trust if the governing instrument was amended prior to December 31, 1972. Conformity through amendment was subsequently recognized by Congress through enactment of Section 2055(e)(3) I.R.C. in 1974. The Tax Reform Act of 1976 extended the amendment date to December 31, 1977, and in the Revenue Act of 1978, Congress extended the time for amendment to December 31, 1978.

The history of the amendment procedure extensions illustrates the continuing problem and difficulty of the qualification of charitable remainder trusts and suggests that the need for further extension pending a possible permanent solution is necessary to prevent an injustice to charitable organizations which Congress clearly intended to benefit. Without the additional extension provided in H.R. 7220 the right to adopt conforming amendments is entirely dependent on the date of the death of the creator of the governing instrument. For example, if Mrs. Fenton had died several months earlier and her will creating the trusts had been admitted to Probate timely, a retroactive amendment would have been permitted under present law. We do not believe that the right to amend with its resulting benefit to charity and the tax deductibility should depend on the fortuitousness of the date of the death of the creator of the trusts.

The Fenton will can be amended to conform with the technical requirements of Sec. 664 without any change in substance whatever. However, to do so requires the extension as provided in H.R. 7220.

The Fenton Estate was appraised at $3,391,396.86 and the denial by the I.R.S. of qualification of the Fenton trusts as charitable remainder unitrusts will result in additional tax in excess of $500,000. These are dollars that were intended to benefit charitable organizations.

The charitable beneficiaries of the Fenton trusts are Overlook House, a retirement home in Cleveland, Ohio; Glenmont Home for Christian Scientists, Inc., in Columbus, Ohio; the Leelanau School in Glen Arbor, Michigan; and the Principia Corporation in St. Louis, Missouri, which operates Principia College.

For the within reasons, we urge your support of H.R. 7220.

H.R. 7263

A BILL To amend the Internal Revenue Code of 1954 with respect to the treatment of retirement and similar plans maintained for nonresident aliens

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) section 404 of the Internal Revenue Code of 1954 (relating to deduction for contributions of an employer to an employees' trust or annuity plan and compensation under a deferred-payment plan) is amended by adding at the end thereof the following new subsection:

"(i) Plan Maintained For Nonresident Aliens.—

"(1) In general.—If the conditions of section 162 or section 212 are satisfied, in the case of a plan described in this section (other than a plan with respect to which deductions are claimed under subsection (a) (1), (2), or (3)) which during the taxable year is maintained primarily for the benefit of persons substantially all of whom are nonresident aliens, subsections (a)(5) and (d) shall not apply (unless the taxpayer elects to apply either of those subsections with respect to such plan) and there shall be allowed as a deduction that portion of amounts paid or accrued with respect to which the requirements of paragraph (2) or (3) of this subsection are satisfied if—

"(A) the benefits provided by the plan are either required by foreign law or set forth in a written document communicated to the active participants;

"(B) in the case of a defined benefit plan, the deduction is limited to amounts paid or accrued in respect of benefits that are reasonably capable of actuarial estimation;

"(C) to the extent the amount taken into account is dependent upon actuarial determinations, the actuarial cost method and assumptions used are in the aggregate reasonable; and

"(D) the amount to be taken into account for the taxable year is determined in a manner consistent with generally accepted accounting principles in the United States applicable to the charging of pension costs against income.

"(2) Funded amount.—If an amount determined under paragraph (1) that has not been allowed previously as a deduction is transferred to a separate trust or fund (whether or not benefits to be provided therefrom are subject to a substantial risk of forfeiture), the requirements of this paragraph are satisfied—

"(A) if—

"(i) in the case of a defined benefit plan—

"(I) the amount transferred and any income earned thereon may not revert to the employer or to the employer's benefit prior to the satisfaction of all liabilities with respect to participants and beneficiaries under the plan; and

"(II) the transferred amount does not exceed the full funding limitation for the year determined under section 412; or

"(ii) in the case of a defined contribution plan—

"(I) the amount transferred and any income earned thereon may not revert to the employer or to the employer's benefit; and

"(II) the amount taken into account is allocated to individual accounts of participants that will be adjusted at least annually for the income and expenses of the fund; and

"(B) if the amount taken into account is transferred not later than the date described in subsection (a)(6).

"(3) Other amounts.—To the extent an amount determined under paragraph (1) does not satisfy the requirements of paragraph (2) and has not been allowed previously as a deduction, the requirements of this paragraph are satisfied if such amount—

"(A) at the time of the payment or accrual, is paid or accrued in respect of benefits that are not subject to a substantial risk of forfeiture; and

"(B) if accrued, represents the actuarial present value of such accrued benefits.

"(4) Direct payments.—A payment, which is not subject to a substantial risk of forfeiture, to a participant or beneficiary by an employer, shall be allowed as a deduction to the extent not previously allowed as a deduction under this subsection.

"(5) Carryovers.—For purposes of this subsection, payments or accruals in any taxable year in excess of the amount allowed as a deduction under this subsection for such year (other than amounts not allowed as a deduction due to the operation of paragraph (6)), shall be treated as a payment or accrual in the next succeeding taxable year.

"(6) Limitations.—The amount allowed as a deduction under paragraph (1) shall not exceed the amount allowed as a deduction without regard to this paragraph multiplied by a fraction, the numerator of which is the payments or accruals made on behalf of active participants who are nonresident aliens, and the denominator of which is the payments or accruals made on behalf of all active participants. The preceding sentence shall not apply if during the taxable year—

"(A) at least 95 percent of all active participants are nonresident aliens, and

"(B) at least 95 percent of the contributions made to or benefits accruing under the plan during the taxable year in respect of active participants are in respect of active participants who are nonresident aliens.

"(7) Accounting method.—Any change in the method (but not the actuarial assumptions) used to determine the amount allowed as a deduction under paragraph (1) shall be treated as a change in accounting method under section 446(e)."

(b) Section 312 of such Code (relating to effect on earnings and profits) is amended by adding at the end thereof the following new subsection:

"(l) Effect of Plans Maintained for Nonresident Aliens.—For purposes of computing the earnings and profits of a foreign corporation for any taxable year, the expenses paid or accrued under a plan described in section 404(i) shall reduce the foreign corporation's earnings and profits to the extent that such amounts would be deductible if the provisions of section 404(i) were applicable to such foreign corporation for its taxable year."

(c) Section 964(a) of such Code is amended by inserting "or 312(l)," after "section 312(k)(3)".

(d) Section 679(a)(1) of such Code is amended to read as follows:

"(1) In general.—A United States person who directly or indirectly transfers property to a foreign trust (other than a trust described in subsection (a) or (i) of section 404) shall be treated as the owner for his taxable year of the portion of such trust attributable to such property if for such year there is a United States beneficiary of any portion of such trust."

Summary

Present law

United States businesses operating abroad often provide deferred compensation for their foreign employees. In many cases, plans are established which cover almost exclusively nonresident alien employees, rather than U.S. citizens working abroad. The foreign operations of the U.S. business may be conducted through a branch of a U.S. corporation or through a foreign subsidiary of a U.S. parent corporation.

General rules relating to deductibility of deferred compensation.—In general, the year in which a taxpayer is allowed to deduct expenses, such as compensation, is determined by its method of accounting. Generally, cash basis taxpayers deduct expenses in the year they are paid, while accrual basis taxpayers deduct the expenses in the year in which all events have occurred which determine the fact of the liability and the amount of the liability can be estimated with reasonable accuracy.

However, the Code provides special rules (sec. 404) for deductions of amounts under pension and other deferred compensation plans, which must be met in addition to the usual requirements for deduction of the amounts as business expenses (secs. 162 and 212). Separate rules apply with respect to qualified and nonqualified deferred compensation plans.

Qualified plans.—In order for a deferred compensation plan to be "qualified" under the Code, contributions under it must be paid into a trust to protect them from the employer's creditors. A number of other requirements must also be met. In particular, the plan must be administered for the sole benefit of employees and their beneficiaries, eligibility to participate must be nondiscriminatory, contributions or benefits must be nondiscriminatory, and benefits must be paid no later than specified dates. Additional requirements must be met if the plan covers self-employed individuals, such as partners. The Employee Retirement Income Security Act of 1974 (ERISA) added a number of additional requirements, including, for example, new eligibility rules, minimum standards for vesting and accrual of benefits, minimum funding standards, maximum limitations on contributions and benefits, a requirement that benefits be paid in certain cases in the form of joint and survivor annuities, and prohibitions on certain dealings between the plan and related parties.

If a plan is qualified, a deduction is allowed at the time a contribution is paid into the plan's trust. The amount of the contribution allowable as a deduction is no less than the amount necessary to satisfy the minimum funding standard prescribed by ERISA. A maximum limitation is also placed on the amount of the contribution which may be deducted. Generally, this may not exceed the "normal cost" of the plan for the year plus an amount which would amortize plan benefit liabilities attributable to past service of employees (if not already included in normal cost under the funding method used by the taxpayer) over a period of no less than 10 years. (The "normal cost" is a measure intended to reflect the ratable share of the increase in plan liabilities to participants resulting from service performed that year. Under some allowable funding methods, a ratable portion of liability for past service of the employees is also included in the year's normal cost.) No deduction is allowed for contributions in excess of the "full funding limitation," the amount by which the accrued liability for benefits of the plan exceeds the value of its assets. Other limitations on deductions also apply if the employer maintains qualified profit sharing or stock bonus plans for his employees. An unlimited carryforward is allowed for contributions in excess of the limitations.

Nonqualified plans.—If a plan of deferred compensation does not meet the requirements for qualification under the Code, a separate rule applies to the deductibility of contributions. The deduction is taken in the taxable year in which an amount attributable to the contribution is includible in the income of the employee. A similar rule applies to deferred compensation arrangements with independent contractors. However, if the plan covers more than one employee, the deduction may be taken only if separate accounts are maintained for each employee. Otherwise, the IRS takes the position that the contribution is never deductible, except in the case of unfunded plans where payment is made directly to the former employees.

Separate accounts are established only for defined contribution plans, which generally require that an amount established pursuant to a formula, which may vary from employee to employee, be contributed to the accounts of the participants. Each employee bears the risk of fluctuations in the value of the investments in his account. Separate accounts are not maintained, however, for defined benefit plans. These plans specify by formula the benefits which participants are to receive on retirement. Contributions to them are based on actuarial calculations of the amounts which will be required to be paid out, generally based in the aggregate on the ages and life expectancies of members of the workforce, likely turnover of participants, and expected investment performance of amounts contributed. The employer bears the risk of investment gain or loss. Because the actuarial assumptions are based on aggregated data, no separate accounts are maintained. Hence, in situations where this rule applies, no deduction is allowed for contributions to a defined nonqualified benefit plan.

Foreign deferred compensation plans—Foreign branch operations.—The Code permits the trust of a qualified plan to be organized under foreign law but does not otherwise expressly waive any of the requirements for qualification. In Letter

Ruling 7904042, the Internal Revenue Service held that if a plan for the benefit of nonresident alien employees did not meet all of the requirements for qualification under the Code (including the provisions added by ERISA), no deduction would be allowable under the rules for qualified plans described above. Instead, the Service held that amounts would be deductible, if at all, only under the rules which apply to nonqualified plans. Since the plans in question were defined benefit palns which did not maintain separate accounts for participants, the Service denied deductions for contributions made to the plans.

Foreign subsidiary operations.—Foreign subsidiaries of U.S. corporations generally do not have U.S. operations which would subject them to U.S. tax, and since their income is thus not subject to U.S. tax, the question of whether a deduction is allowed for contributions to a plan for nonresident aliens does not have the same direct effect on their U.S. tax liability as in the case of a foreign branch of a U.S. corporation. However, the treatment of the contribution in computing the foreign subsidiary's accumulated profits has important consequences in determining the indirect foreign tax credit which the U.S. parent corporation is allowed with respect to dividends received from the foreign subsidiary.[1]

Generally, if a U.S. corporation owns at least 10 percent of the voting stock of a foreign corporation from which it receives a dividend, the U.S. corporation is deemed to pay the amount of foreign income taxes paid by the foreign subsidiary on the accumulated earnings from which the dividend was paid. The U.S. corporation may then, within limitations, claim a credit against its U.S. tax liability in the amount of the foreign income taxes deemed paid by it. Under regulations, the determination of foreign taxes paid on accumulated earnings is made on a year-by-year basis, starting with the most recent year. If only part of the accumulated earnings of that year are paid out, only a proportionate part of the foreign income taxes paid with respect to the earnings for that year are deemed paid. Thus, if a dividend of a given size is paid, more of the foreign income taxes paid by the foreign subsidiaries will be deemed to have been paid by (and thus would be creditable by) the U.S. parent if the accumulated earnings of the subsidiary are smaller than if they are larger—because a proportionately larger share of the accumulated earnings would be paid out in the dividend, resulting in a greater proportion of the foreign taxes being deemed paid.

The deduction issue discussed in connection with foreign branches can also be relevant in the case of a foreign subsidiary if it conducts a U.S. business, the taxable income from which must be determined., or if it is controlled foreign corporation. (CFC).[2]

In the case of a CFC, subpart F (secs. 951–64 of the Code) provides that, in general, the United States shareholder must currently include in their income certain types of tax haven income of the corporation and certain types of passive investment income. Generally, the amount of this income to be taken into account is reduced by deductions properly allocable to that income, so if foreign pension costs are so allocable, it is necessary to determine whether and when they are deductible. Moreover, an indirect foreign tax credit similar to that described above may be allowed to the U.S. shareholder with respect to the amount which the shareholder must include in income. The credit is equal to the proportionate part of the foreign income taxes paid on the earnings and profits of the CFC from which the distribution is deemed to be made. Thus, questions similar to those described above arise as to the size of the earnings and profits.

In Letter Ruling 7839005, the Internal Revenue Service considered an accrual basis CFC which established an irrevocable balance sheet reserve for pension expenses. The taxpayer contended that the CFC's earnings and profits should be reduced by the amount of its pension liability which have properly been accrued. The Service held, however, that earnings and profits could be reduced only to the extent of pension payments actually made. The Service did not view as controlling the taxpayer's argument that this result would distort (generally by reducing) its allowable indirect foreign tax credit with respect to dividend distributions from the CFC.

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[1] Section 406 of the Code permits, in limited instances, a U.S. parent corporation with a qualified plan to make contributions on behalf of employees of a foreign subsidiary who are U.S. citizens. In such cases, a deduction is allowed to the foreign subsidiary.

[2] Generally, a foreign corporation is a CFC if more than 50 percent of the voting power is held by "United States shareholders," that is, U.S. persons each of whom holds 10 percent or more of the voting power.

Foreign trusts with U.S. beneficiaries.—The Code provides that if a U.S. person transfers property to a foreign trust, and a U.S. person is the beneficiary of any part of the trust, then the transferor is treated as the owner of the transferred trust property and therefore is taxable on the income earned on that part. Moreover, if the trust does not have a U.S. beneficiary at the time of the transfer but later acquires one, the transferor is subject to tax on all the undistributed net income on amounts it previously transferred to the trust. The Code expressly provides that these rules do not apply to foreign trusts established under qualified plans. However, there is no similar exception for foreign trusts under nonqualified plans. Thus, if a U.S. corporation makes a contribution to a foreign trust of a nonqualified plan, it is possible that the corporation would be taxable on the income earned on the contribution, either immediately if the trust has a U.S. person as a beneficiary, or subsequently if one of the plan participants or his beneficiary becomes a U.S. citizen or resident.

Issues

The issues are whether or not, in the case of a nonqualified plan of deferred compnsation maintained for the benefit of nonresident aliens:

(1) special rules should be prescribed with respect to the allowability of deductions with respect to the plan;

(2) special rules should be prescribed as to the effect of the plan on earnings and profits; and

(3) it should be specified that the rules relating to foreign trusts with U.S. beneficiaries do not apply to contributions to such a trust under the plan.

Explanation of provisions

Allowance of deductions.—The bill would provide that, in the case of a nonqualified deferred compensation plan which is maintained primarily for the benefit of persons substantially all of whom are nonresident aliens, the general rules regarding the timing and allowability of deductions for contributions will not apply (unless the taxpayer elects to have those rules apply to the plan). Instead, if the contributions otherwise qualify for deduction as business expenses, special rules for deductibility are prescribed.

General rules.—Four general requirements apply to any deductions (except deductions for direct payments, described below) to be taken under the special rules. First, the benefits provided by the plan must be either required by foreign law or set forth in a written document communicated to the active participants. Second, in the case of a defined benefit plan, the deduction is limited to amounts paid or accrued in respect of benefits that are reasonably capable of actuarial estimation. Third, to the extent the amount taken into account is dependent upon actuarial determinations, the actuarial cost method and assumptions used must in the aggregate be reasonable. Fourth, the amount to be taken into account for the taxable year must be determined in a manner consistent with generally accepted accounting principles in the United States applicable to the charging of pension costs against income.

In addition to these general requirements, special rules are prescribed which must be met in both of the circumstances which could give rise to a liability for deferred compensation other than a direct payment: the payment of contributions to a trust or fund on the one hand, and other payment or accrual on the other hand.

Trust contributions.—If an amount is transferred to a separate trust or fund and has not been allowed previously as a deduction, then, whether or not benefits to be provided from the trust are subject to a substantial risk of forfeiture, a deduction is allowed for the amount transferred if the conditions described above under "General rules" are met and if certain other requirements are met. In the case of a defined benefit plan, the amount transferred and any income earned thereon must not revert to the employer or to the employer's benefit prior to the satisfaction of all liabilities with respect to participants and beneficiaries under the plan. Also, the transferred amount must not exceed the full funding limitation for the year. In the case of a defined contribution plan, the amount transferred and any income earned thereon must not revert to the employer or to the employer's benefit, and the amount taken into account must be allocated to individual accounts of participants that will be adjusted at least annually for the income and expenses of the fund. As is currently the case with qualified plans, a taxpayer will be allowed a deduction with respect to a taxable year if the contribution on which the deduction is based is made by the time the taxpayer files a timely return for that year.

Other payments and accruals.—If the above requirements relating to payment into a trust or fund are not met, but the conditions described above under "General rules" are satisfied, then a deduction is allowed at the time of payment or accrual, if the amount is paid or accrued in respect of benefits that are not subject to a substantial risk of forfeiture, and, if the amount is accrued, it represents the actuarial present value of such accrued benefits.

Direct payments.—The bill also provides that, if a deduction has not previously been allowed under the above rules, it will be allowed when a payment, which is not subject to a substantial risk of forfeiture, is made to a participant or beneficiary by an employer.

Nonresident alien participation.—As described earlier, these rules apply only where substantially all of the beneficiaries are nonresident aliens. The bill provides for a reduction of the deduction otherwise allowable where not all the active participants are nonresident aliens. Generally, the amount otherwise allowable is to be multiplied by a fraction, the numerator of which is the payments or accruals made on behalf of active participants who are nonresident aliens, and the denominator of which is the payments or accruals made on behalf of all active participants. However, no reduction is required, if during the taxable year at least 95 percent of all active participants are nonresident aliens, and at least 95 percent of the contributions made to or benefits accruing under the plan are in respect of active participants who are nonresident aliens.

Other rules.—The bill allows an unlimited carryforward of amounts not currently deductible (except amounts disallowed because of the participation of individuals other than nonresident aliens). The bill also requires that whatever accounting method is used to determine the deductible amount must be used consistently. Changes in the accounting method (but not actuarial assumptions) would require the permission of the Service.

Effect on earnings and profits.—The bill would provide that, if an amount would be deductible under the special rules provided by the bill, the earnings and profits of the corporation are to be reduced to the same extent.

Foreign trusts.—The bill would make it clear that in the case of a contribution to a foreign trust subject to the special deduction rules, the corporation making the contributions is not treated as the owner of part of the trust merely because the trust has or acquires U.S. beneficiaries.

Effective date

The bill would be effective upon enactment.

Revenue effect

The revenue estimate for this bill is not yet available.

STATEMENT OF HON. BILL GRADISON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OHIO

We are all aware that provisions of the Internal Revenue Code sometimes penalize individual or corporate taxpayers. My colleagues and I have introduced H.R. 7263 to amend sections of the Code that have unnecessarily taxed U.S. corporations and foreign subsidiaries that maintain pension plans for nonresident aliens.

H.R. 7263 clarifies conditions under which a domestic corporation may claim a tax deduction for all ordinary and necessary expenses incurred during the taxable year in connection with foreign pension plans. The bill also prescribes requirements foreign branch employers must meet before claiming a deduction. In addition, the amount of the deduction allowed must be determined in a manner consistent with the generally accepted U.S. accounting principles which are applicable to the charging of pension costs against income. Amending section 404 of the Code will allow domestic corporations a tax deduction, subject to certain limitations, for funding pension plans for nonresident aliens.

The bill similarly recognizes foreign pension plan expenses of foreign subsidiaries, providing a current reduction in the earnings and profits of a foreign corporation for expenses paid or accrued under a pension plan. Our amendment to section 312 will assure that these pension expenses will be accounted for in the same manner as expenses of foreign branches of domestic corporations. Passage of H.R. 7263 will confirm legally the accepted and long-established procedure used by foreign subsidiaries to account for pension plan expenses.

During this time of recession, Congress must strive to convince American business that unreasonable laws or unreasonable interpretations of laws will not go unnoticed. The amendments to the Internal Revenue Code included in H.R. 7263 will stop the unreasonable practice of penalizing American corporations and their subsidiaries for complying with foreign laws. It is essential that we act to ensure the competitive vitality of our companies abroad. I firmly believe that H.R. 7263 will resolve legal discrepancies and ease unnecessary restrictions on American business interests operating in foreign countries.

AMERICAN BAR ASSOCIATION,
Washington, D.C., June 17, 1980.

JOHN M. MARTIN, Jr., Esq.
Committee on Ways and Means,
House of Representatives.

DEAR MR. MARTIN: While the Section of Taxation of the American Bar Association will not be in a position to obtain the necessary American Bar Association clearances in time to testify at the hearings noted above, we do have a particular interest in H.R. 7263 which proposes to amend the Internal Revenue Code of 1954 with respect to the treatment of retirement and similar plans for non-resident aliens.

Our Committee on Employee Benefits has been studying this matter and is, in fact, presently voting on a report dealing with the subject.

We hope to be in a position to submit for the record a statement of individual comments on or before July 3, 1980. The statement will generally support the provisions of H.R. 7263, but will also note some of the issues that should receive particular attention.

If you have any questions, please let me know.

Cordially,

EDWARD N. DELANEY.

AMERICAN STANDARD INC.,
New York, N.Y., June 25, 1980.

SUBCOMMITTEE ON SELECT REVENUE MEASURES,
Committee on Ways and Means,
U.S. House of Representatives.

DEAR SIRS: This written statement is in lieu of personal appearance at the public hearing before your committee schedule for June 26, 1980. American Standard Inc. supports enactment of H.R. 7263.

American Standard is a major worldwide manufacturer in four diversified areas: Transportation Products, Building Products, Security and Graphic Products and Construction and Mining Equipment.

The Company and its affiliates conduct manufacturing operations in more than 20 countries. American Standard employs about 51,000 people and is owned by approximately 41,000 shareholders.

Two of the foreign countries in which subsidiaries of ours have substantial operations are Germany and Italy, in both of which large amounts are accrued annually for pensions or terminal pay for employees under state-controlled or private plans which meet local requirements. In neither country is funding a requirement for tax deductibility.

The Internal Revenue Service has taken the position that in computing the foreign tax credit for Germany and Italian corporate income taxes deemed paid as a result of dividend remittances from these countries, the earnings and profits of the German and Italian subsidiaries are to be increased by accrued but unfunded Germany or Italian pension or termination pay contributions. This position results in a substantial reduction in the foreign tax credit that would otherwise be available and thus imposes a tax on their American parent corporations which is not borne by any non-American-owned enterprise doing business in Germany or Italy.

The proposed legislation would remedy this defect and restore the foreign tax credit to its intended function. We strongly support this legislation and believe it to be not only in the interest of companies similarly situated to ours, but also of the United States Government. The latter is true because, in the absence of such remedial legislation, the only effective way in which we could help ourselves would be to fund the German and Italian plans, which would increase ou foreign tax credit, but at a substantial cost. This would have the undesirabl consequence of reducing our dividend remittances from these countries, adversel affecting the United States balance of payments.

Very truly yours,

Henry H. Steiner,
Vice President and Tax Counsel.

Bank of America,
San Francisco, Calif., June 18, 1980.

Hon. Daniel Rostenkowski,
Chairman, Subcommittee on Select Revenue Measures, Committee on Ways an Means, House of Representatives.

Dear Congressman Rostenkowski: I understand that your Subcommittee ha scheduled a hearing on June 26 on H.R. 7263, a bill that would clarify the ta treatment of employee benefit plans maintained overseas by U.S. employers primarily for the benefit of nonresident aliens.

Bank of America strongly supports H.R. 7263, as we believe it would correc a serious anomaly in the law inadvertently created, or failed to be addressed in 1974 by the Employee Retirement Income Security Act. For that reason, w urge that this corrective legislation be adopted retroactively to the effective dat of ERISA.

Sincerely,

A. W. Clausen, *President.*

Burroughs Corp.,
Washington, D.C. June 27, 1980.

Hon. Dan Rostenkowski,
Chairman, Subcommittee on Select Revenues Measures, Committee on Ways and Means, U.S. House of Representatives.

Dear Mr. Chairman: Burroughs Corporation supports enactment of H.R. 726 which would amend the Internal Revenue Code of 1954 with respect to the treatment of retirement and similar plans maintained for non-resident aliens.

Burroughs is a leading worldwide manufacturer and marketer of data processing and office automation systems, business machines and office supplies. We market our products through more than 1,200 offices in over 120 countries and operate more than 60 engineering and manufacturing centers in nine countries. Worldwide employment is 55,000. Our worldwide revenues in 1979 were $2.8 billion.

H.R. 7263 clarifies the tax treatment of contributions made under retirement plans that are established by U.S. businesses primarily to provide benefits for certain foreign employees.

The Employee Retirement Income Security Act of 1974 (ERISA) provided only limited rules concerning the tax treatment of these contributions. This lack of legislative guidance has created problems for the Internal Revenue Service and the business community.

The legislation would correct the current uncertainty by establishing statutory rules concerning the kinds of contributions that would be deductible for Federal income tax purposes. These rules would provide certainty for the business community and allow it to offer employees competitive wages and retirement benefits. Compensation packages of this type will enable our businesses to attract qualified employees and to more effectively compete with foreign businesses.

Meeting the requirements of both U.S. law and foreign law is often a difficult, time-consuming process that frequently results in plans that are inconsistent with customary foreign local practices. These circumstances would significantly increase our legal and administrative costs (and, in some cases, our benefits costs) and would place us at a competitive disadvantage. We believe that no justifiable social purpose is served by extending to non-resident aliens the protections contained in ERISA which were designed for U.S. employees.

Burroughs strongly endorses H.R. 7263 amending the Internal Revenue Code of 1954. We urge the Subcomimttee on Select Revenue Measures to report out this bill favorably at the earliest possible date.

Sincerely,

J. Paul Leebrick,
Vice President, Government Relations.

CATERPILLAR TRACTOR CO.,
Peoria, Ill., June 30, 1980.

Hon. DAN ROSTENKOWSKI,
Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives.

DEAR MR. CHAIRMAN: This is to urge favorable consideration by your committee on H.R. 7263—a bill to amend the Internal Revenue Code to clarify the tax treatment of retirement and similar plans maintained primarily for nonresident aliens.

Caterpillar is a large U.S. multinational corporation that designs, manufactures and markets earthmoving, construction and materials handling equipment and diesel and natural gas engines. It operates in 13 countries outside the U.S. through several subsidiary and affiliated corporations. At the end of 1979, Caterpillar had 89,400 employees. About 20,200 of these—most of which were foreign nationals—were employed outside the U.S.

Caterpillar has a vital interest in this legislation since it is presently engaged in a controversy with the IRS on one of the issues H.R. 7263 was designed to clarify. In determining the earnings and profits of our Japanese affiliate the IRS has denied a deduction for the addition to the company's accrued termination payment reserve, thereby reducing the allowable U.S. foreign tax credit (for Japanese taxes paid) on dividends received from this company, in spite of the fact that the amount accrued was just the amount necessary to increase the total reserve to the amount which would be payable to the company's employees if they had all retired voluntarily at the end of the year—the minimum the company will eventually have to pay in all events.

The IRS adjustment was made primarily because the Japanese plan did not meet the qualification requirements of U.S. tax law. It is unreasonable for the U.S. to impose its qualification standards on the retirement plans of foreign corporations in order that contributions to such plans be deductible for U.S. tax purposes. Different methods of addressing retirement pay in different countries should be recognized as valid. The liability under these foreign plans is no less real than under U.S. plan concepts, and any U.S. tax treatment which fails to recognize this fact is unrealistic and unfair.

Section 4(b)(4) of the Employee Retirement Income Security Act of 1974 (ERISA) specifically exempts foreign plans primarily for the benefit of nonresident aliens from all the requirements of Title I of that act. However no exemption of such plans from the tax provisions (Title II) of ERISA was provided, presumably because "such plans would have no need to seek tax deferral qualification." (See Conference Report 93–1280, 2nd Session, p. 291, 8/12/74.) Perhaps through oversight Congress ignored the U.S. tax deduction problems of foreign branch and subsidiary plans and the fact that they often cannot be made to comply with ERISA requirements. This has resulted in considerable uncertainty in the tax area, inequitable treatment between foreign and U.S. plans, and potential litigation.

Accordingly, Caterpillar urges that the Internal Revenue Code be amended to eliminate these tax inequities and uncertainties. With minor exception, it appears H.R. 7263 would accomplish that purpose; so we strongly encourage your committee to report this bill out favorably.

If the Committee or its staff have any questions or would like further elaboration on any point, please call Albert C. Greer, telephone number (309) 675–4478, or write to him at 100 N.E. Adams Street.

Respectfully submitted,

G. A. SCHAEFER,
Vice President.

STATEMENT OF CHARLES W. WHEELER, SENIOR TAX ATTORNEY, TAX POLICY CENTER, CHAMBER OF COMMERCE OF THE UNITED STATES

The Chamber of Commerce of the United States is the world's largest business federation. On behalf of its more than 98,600 business and trade association members, we welcome this opportunity to support H.R. 7263 which would allow U.S. companies operating abroad to treat the costs of maintaining pension and similar benefit plans for their foreign employees as they do other legitimate overseas business expenses.

The ability of U.S. corporations operating abroad to compete effectively has been threatened as a result of positions taken recently by the Internal Revenue

Service. In a private letter ruling (LTR 7904042) and technical advice memorandum (LTR 7839005), the IRS has stated that it will apply the tax rules of ERISA and related provisions of the Internal Revenue Code to determine whether the costs of maintaining a pension plan for foreign workers employed abroad can be deducted for income tax purposes by a company doing business through a foreign branch, or can be taken into account in figuring earnings and profits of a foreign subsidiary. Since foreign pension plans must comply first with foreign law and local custom, few, if any, such plans will also meet the requirements of ERISA and the Code. Companies operating overseas will be forced to either abandon their pension plans, thus lowering the quality of the work force they can attract, or pay U.S. tax on income that has been expended or accrued to pay pension costs. In either event, they will be put at a competitive disadvantage when compared to foreign owned companies competing in the same market.

The foreign pension plans affected by this bill provide benefits almost exclusively to foreign workers. No U.S. interests would be served by requiring such retirement plans to comply with the tax provisions of ERISA and the Code. The primary intent of ERISA was to provide American workers with improved private pension plans. The interests of the American worker are not affected however, by the quality of the pension offered abroad to foreign workers. In fact, Congress appeared to recognize this by specifically excluding foreign pension plans intended primarily for foreign workers from the coverage of the labor and termination insurance provisions of ERISA.

It is the responsibility of each nation to determine whether it will encourage private industry to provide retirement plans for its citizens and under what rules that will be accomplished. Local traditions and customs concerning support of the elderly, age of retirement, and the level of governmental social responsibility can result in the adoption of very different retirement systems. In the context of their own circumstances, a foreign nation's pension rules may be superior to our own. The rules for qualifying a pension plan under ERISA were intended to resolve problems that developed in the operation of U.S. retirement plans. No thought was given to whether they would be appropriate for other nations.

The United States should not attempt to "export" its determination of how retirement plans should be structured. The adoption of H.R. 7263 would allow American companies operating overseas through branches or subsidiaries to compete on a more equal basis with their foreign counterparts. Under the bill, American companies would be able to offer the same quality and type of retirement plans as do local companies without unfairly increasing their tax burden. For these reasons, the U.S. Chamber supports the adoption of H.R. 7263.

STATEMENT OF CITIBANK, N.A.

Citibank endorses the principle of H.R. 7263 and strongly urges its passage. This bill would remove a serious irritant in our relationships with other countries, which understandably object to the application of U.S. tax law rules and retirement plan policies to plans for the benefit of their citizens. At the same time, the bill would limit U.S. tax deductions to expenses in connection with bona fide retirement plans. At present, U.S. companies have only the choice of offending host countries by attempting to comply with U.S. tax law, or suffering a U.S. tax penalty in order to comply with local law on retirement plans.

As a leading global financial services company operating in many countries around the world, Citibank and its parent, Citicorp, must be sensitive to the needs and wishes of the host countries in which it operates. Citibank has endorsed the guidelines published by twenty three member nations as of the Organization for Economic Cooperation and Development, which require respect for the internal objectives of host countries, and observation of the letter and spirit of local laws. Host countries are never more sensitive to these issues than with respect to the treatment of their citizens employed by foreign companies. They rightly insist that any such company observe their laws, policies and customs. These rules are fashioned to preserve and protect the culture and social institutions of each country. The authorities in these countries understandably object, as would the United States, to any attempt to impose external standards.

It is clear that most of the rules in Code Sections 401 et seq were adopted to effectuate U.S. social policies, not to generate tax revenues. These rules are built on a foundation of assumptions such as the characteristics of the U.S. workforce, and the sources of economic support available to retired workers in the U.S. For the employer engaged in business overseas, this creates a direct conflict with local country regulation. Where a foreign country encourages, or even requires, retirement benefits, the local law will set forth how and when such benefits shall be paid by the employer, and provided for by funding that obligation. It is often not possible to comply with both foreign local law and industry practice, and the U.S. Internal Revenue Code. Thus the employer is placed on the horns of a dilemma. On the one hand, if the employer seeks to satisfy employee expectations by following local customs, or in the worst case, is compelled by local law to adopt certain specific retirement policies and follow specific rules, then the Internal Revenue Code will levy a penalty in the form of a refusal to recognize the cost of funding and paying those benefits as a deductible business expense. On the other hand, if local law does not prohibit it, and the employer establishes a retirement plan which complies with U.S. tax rules, then the employer is almost certain to be out of step with other non-U.S. employers in that country, thus generating hostility on the part of the employees and resentment on the part of government authorities who see their institutions being overridden.

H.R. 7263 will correct this by limiting the U.S. tax law rules applicable to retirement plans for foreign nationals to those few elements necessary to establish the bona fide character of the plan. This is all that needs to, and should, be done. If the U.S. is satisfied, as the provisions of H.R. 7263 would ensure, that a U.S. employer operating in a foreign country has in fact incurred an expense in connection with the employment of non-U.S. persons in that country, then the U.S. interest in the matter is ended.

WASHINGTON, D.C., *July 3, 1980.*

Hon. DAN ROSTENKOWSKI,
Chairman, Subcommittee on Select Revenue Measures,
Committee on Ways and Means, U.S. House of Representatives.

DEAR MR. CHAIRMAN: These comments in support of H.R. 7263 are submitted on behalf of The Coca-Cola Company. Generally, H.R. 7263 would clarify and codify existing law relating to the U.S. tax treatment of nonqualified pension plans maintained by foreign subsidiaries of U.S. corporations and U.S. corporations operating abroad through branches.

By way of introduction, it is important to note that the statutory rules in the Internal Revenue Code have reflected, at least since 1942, considerations beyond accurately determining the current income of an employer maintaining a plan of deferred compensation. In most instances, when an expense is incurred by a taxpayer in its business, the other party to the transaction has a corresponding amount of income, and the aggregate U.S. tax base is not reduced. For example, if a taxpayer pays or accrues wages, rent, or interest, the recipient will be subject to tax on these amounts, typically in the same taxable year. Because virtually all employees use the cash method of accounting, this matching of expense by the employer and income to the employee may not occur with respect to deferred compensation, and Federal revenues may be significantly reduced. It has been our long-standing policy that such revenue reductions are appropriate only in the case of deferred compensation plans which meet certain minimum standards. Originally, these standards were basically the nondiscrimination requirement and the funding requirement (i.e., that the amounts set aside be placed in trust to protect the employees). In 1974, the Congress added a number of additional requirements (e.g., minimum vesting and participation standards, joint and survivor annuity requirements, and benefit commencement requirements).

If these standards are satisfied, the employer is allowed a current deduction but the employee is not subject to tax until benefits are received. If these standards are not satisfied, generally both the allowance of the employer's deduction and the employee's receipt of income will occur in the same year. As a general matter, if the plan is funded, these events will occur when the employee's rights become vested; if the plan is not funded, these events will occur when benefits are paid to the employee. An exception to the foregoing involves funded plans under which separate account is not maintained for each employee; in such a case, the employer is never allowed a deduction. By contrast, under generally applicable tax principles, an accrual method employer's deduction would be allowable for the year in which the services are performed (i.e., the year in which the benefits are earned).

The foregoing analysis demonstrates that the existing statutory rules for deducting deferred compensation costs do not purport to match income and expense

from the standpoint of the employer. Rather, these rules are exceptions to thi
generally applicable principle. These rules are premised on the assumption tha
both the employer and, more especially, the employee are U.S. taxpayers, and ca
be justified where this is the case. Where this is not the case, the social polic
and anti-tax avoidance factors underlying these rules are irrelevant, and ther
is no reason to depart from the generally applicable principle and allow the em
ployer to deduct the deferred compensation earned currently by its employees.

The extent to which the foregoing considerations are reflected in existing la
is uncertain. The Internal Revenue Service has issued one private letter rulin
(involving foreign branches of U.S. corporations) and one technical advice mem
randum (involving foreign subsidiaries of U.S. corporations) in which it refuse
to give any effect to these considerations in applying the relevant provisions o
the Code. Rather, the Service has taken the positions that the employer is neve
allowed a deduction for contributions to a nonqualified funded plan under whic
a separate account is not maintained for each employee and that the expense o
an unfunded plan may be taken into account only when benefits are paid rathe
that when earned. Moreover, if this statutory language is read literally, no dedu
tion is ever allowable for the cost of nonqualified pension plans for nonreside
aliens employed outside the United States. (This follows from the fact that se
tion 404(a)(5) of the Code allows the employer a deduction only when the d
ferred compensation is includible in the gross income of the employee, and sectio
862(a)(3) and 872(a)(1) provide that compensation for personal services pe
formed abroad is income from sources without the United States and is not i
cludible in the gross income of a nonresident alien. Thus, since nothing is eve
includible in the gross income, nothing is deductible by the employer.) Even th
Income Tax Regulations of the Treasury Department do not construe sectio
404(a)(5) this strictly to deny deductions in all cases, but have not dealt wit
all of the problems in this area adequately, as demonstrated by the positio
taken by the Service.

H.R. 7263 would end the existing confusion in this area by providing speci
and comprehensive rules under which both foreign subsidiaries and forei
branches of U.S. corporations are to take account of the expense of pension pla
maintained primarily for the benefit of persons substantially all of whom a
nonresident aliens. This bill would provide specific rules for determining th
amount of pension expense attributable to the current taxable year, thus resulti
in a reasonable measure of the employer's actual income for that year.

In its testimony before the Subcommittee on H.R. 7263, the Treasury Depar
ment supported the principles underlying H.R. 7263, primarily for the reaso
set forth above, but stated that this legislation should apply prospectively on
insofar as it applies to foreign branches of U.S. corporations. It is indeed anom
lous for the Treasury Department to support legislation on the ground that it
reasonable and sound and at the same time to take the position that a differe
rule—presumably one that is not reasonable and sound—should apply for t
past. As noted above, if the provisions of the Internal Revenue Code relating
deducting the cost of nonqualified pension plans maintained for nonreside
aliens are read strictly, no deduction is ever allowable to the employer. Thus,
seems clear that when section 404(a)(5) was last amended in 1969, an unintend
oversight occurred, and H.R. 7263 should be regarded as correcting this oversig
Thus, it would be entirely appropriate for this legislation to be made retroacti
to 1969 (the effective date of present section 404(a)(5)). In this regard, it
important to note that the Treasury Department supports a retroactive effecti
date for the amendment which H.R. 7263 would make to section 679 on t
ground that the scope of that section as originally enacted and now exists w
also too broad.

Another consideration supporting retroactivity is the fact that a major, b
not the exclusive, reason why the funded pension plans of foreign branches
U.S. corporations are not qualified are the additional requirements for qualifi
tion imposed by the Employee Retirement Income Security Act of 1974. Wh
making the provisions of H.R. 7263 as they relate to these plans retroactive
the effective date of these additional requirements would not be a complete so
tion, it would as a practical matter be reasonably adequate.

In summary, H.R. 7263 is a soundly conceived bill and, with the effective da
change noted above, should be promptly enacted.

Sincerely yours,

WILLIAM P. MCCLURE,
Counsel, on Behalf of
The Coca-Cola Co.

THE CONTINENTAL GROUP, INC.,
Stamford, Conn., July 2, 1980.

SUBCOMMITTEE ON SELECT REVENUE MEASURES,
Committee on Ways and Means,
U.S. House of Representatives,
Washington, D.C.

GENTLEMEN: We are pleased to have the opportunity to express to you our views in support of the enactment of H.R. 7263, a bill which would amend the Internal Revenue Code of 1954 insofar as it governs the income tax treatment of costs attributable to retirement and similar plans of deferred compensation maintained for nonresident aliens. This written statement is being submitted in lieu of a personal appearance at the public hearing which your Committee held on June 26, 1980.

The Continental Group, Inc. operates worldwide with 62,000 employees engaged in packaging, natural resources and financial services businesses. We conduct overseas operations through branches, subsidiaries and associated companies. We manufacture in 18 countries outside the U.S. wherein we employ a work force of 21,000 men and women, substantially all of whom are covered by private pension plans supported by our company. As in the U.S., these private industry supported pension plans are necessary to attract and maintain a stable work force, an essential element to remaining competitive in today's worldwide marketplace.

The basic issue which H.R. 7263 addresses is whether, in the conduct of our foreign operations through branches, subsidiaries and associated companies, we should be required to meet the same strict tests for deductibility of costs attributable to foreign pension plans maintained for our nonresident alien employees as are applied in determining the deductibility of similar costs related to plans covering U.S. persons.

These tests applicable to plans providing benefits for U.S. employees are, in general, motivated by U.S. social and tax policy concerns which are not present in the case of foreign plans maintained for nonresident aliens. The requirement for funding through an independent trust, for example, is designed to insure the security of pension promises. This is certainly a valid concern but is one which other countries have addressed differently. The payment requirement as it applies to non-qualified plans, was designed to avoid a mismatching of expense to the corporation and income to the employee. There is no need for such a requirement where the employee is a nonresident alien because he would not be taxed on the income in the first instance.

The Internal Revenue Service has, nonetheless, taken the position in a Private Letter Ruling and in a Technical Advice Memorandum that, without regard to the motivation for the various strict tests applicable to plans covering U.S. employees, those same strict tests must be applied in the case of foreign plans covering nonresident alien employees. H.R. 7263 would provide a very necessary different direction in this respect. The Bill would permit U.S. taxpayer companies, in the calculation of their U.S. taxable income arising either from branch activities or from dividends, to use rules which approximate normal accrual rules for purposes of testing the deductibility of costs relating to pension plans benefiting nonresident aliens.

In light of the position of the Internal Revenue Service and absent the Cogressional direction which H.R. 7263 would provide, we have effectively been faced with two choices:

1. The prospect of incurring substantial nondeductible costs in order to maintain necessary pension plans for our non-U.S. employees, or
2. The prospect of attempting to obtain qualification for plans covering these employees under the strict tests of U.S. law.

The latter alternative has really not been a practical one. The plans in question are maintained for foreign employees and are typically different for each country in which we operate, being governed by the laws of the particular foreign country having primary jurisdiction. These foreign laws do not necessarily parallel the U.S. in either motivation, theory or application. Instead, they reflect considerations of tax policy and social benefit deemed necessary to achieve the foreign jurisdiction's own goals and priorities. At best, an attempt to simultaneously meet the requirements of both U.S. and foreign law would be a difficult, time-consuming and costly process that would result in foreign plans that are not in conformity with and competitive with customary local practice. At worst, such an attempt would be fruitless because of irreconcilable conflicts.

Germany is a good example. There, the local deductibility of our substantial pension costs are assured not by the use of a U.S.-type qualified plan and related funded trust, but by an accrual of the pension liabilities on the balance sheet. German law specifies its own set of tests and criteria which must be satisfied in order to obtain the tax deduction. Funding of these pension costs in a manner strictly comparable to that employed in the U.S. is effectively discouraged. Were U.S. concepts to be strictly employed in Germany, either the employees would be taxed currently in Germany on their future pension benefits or the sponsoring subsidiary corporation would be denied a German tax deduction.

We have reluctantly pursued the former alternative, namely the prospect of incurring substantial non-deductible costs in the course of maintaining our very necessary foreign pension plans. We have done this both because the alternative is unworkable and because we operate abroad in the main part through subsidiaries and are of the opinion that the treatment for which H.R. 7263 would provide is arguably already available to us under Section 902 of the Internal Revenue Code with respect to dividends. This, however, has been far from a satisfactory solution because the uncertainty created by the Internal Revenue Service position has discouraged the payment of dividends and led to what amounts to cost-mandated foreign reinvestment. Such a course of action is, in our view, counterproductive in an economic environment where not only our nation's balance of payments deficit but also U.S. industry's need for additional investment capital to stimulate the economy, should be encouraging repatriation.

We believe that no justifiable social and tax purposes are served by a policy of extending to pension plans covering nonresident alien employees the same strict tests of the Internal Revenue Code as are applicable to plans covering U.S. persons. Congress has, itself, already agreed to this point when it excluded plans maintained primarily for the benefit of nonresident aliens from Titles I and IV, Employee Retirement Income Security Act (ERISA). We believe instead that the pension methods which are deemed by foreign authorities to provide adequate protection for their own nationals should be honored and accepted by the United States.

H.R. 7263 has incorporated into its provisions a number of reasonable safeguards to insure that the U.S. tax treatment of foreign pension costs is not unduly influenced or controlled by foreign law. Thus, it requires that reasonable actuarial methods be used to determine pension liabilities and that U.S. generally accepted accounting principles serve as an overriding measure of limitation on the deduction which would be allowed. We support these various limitations as reasonably necessary.

For the reasons discussed above, The Continental Group, Inc. strongly endorses H.R. 7263 and urges its enactment. We urge this Subcommittee to report out H.R. 7263 favorably at the earliest possible date.

Yours very truly,

FRANCIS C. OATWAY,
Vice President, Taxation.

DEERE & CO.,
Moline, Ill., June 25, 1980.

Hon. DAN ROSTENKOWSKI,
Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives.

DEAR MR. ROSTENKOWSKI: We at Deere & Company have just been informed that a bill dealing with the United States taxation of foreign retirement plans has been introduced in the House as H.R. 7263. The bill proposes to exempt foreign retirement plans maintained for nonresident aliens from U.S. rules and regulations by exempting such plans from Title II of the Employee Retirement Income Security Act of 1974 (ERISA)—the section of ERISA which contains the ERISA amendments to the Internal Revenue Code.

It is our understanding that plans primarily for the benefit of nonresident aliens maintained outside the United States were exempted from all requirements of Title I of ERISA by Congress in Section 4(b)(4) of ERISA. However, a parallel provision exempting such plans from the requirements of ERISA was not inserted in Title II of ERISA, thus leaving a gap in the legislation with regard to foreign plans.

Notwithstanding the Title I exemption, the Internal Revenue Service has recently taken the position that a United States employer may deduct contributions to a foreign plan only if the plan is a fully qualified plan, i.e. it complies with all of the amendments to the Internal Revenue Code made by Title II of ERISA. This position was announced by the Internal Revenue Service in Private Letter Ruling 7904042.

Such a position, if warranted, places an undue burden upon United States employers. The Service, in promulgating this position, is forcing United States employers to impose United States standards on foreign pension plans maintained for nonresident aliens. Such a position ignores the complexities of international laws. Moreover, Congressional sanctioning of that position would stray far beyond the limitations of the laws of the United States.

In fact, Congress already recognized these limitations when, in first deliberating on ERISA legislation in 1974, Congress noted: "such plans [foreign pension plans] would have no need to seek tax deferral qualification". (See ERISA Conference Report, H.R. Rep. 93-1280, 93d Cong., 2d Sess. 291 (1974).)

In light of the fact that Congress had already resolved the issue in favor of foreign pension plans back in 1974, it is evident that the Internal Revenue Service has incorrectly interpreted the void in Title II of ERISA as a signal by Congress that such plans are to be subject to the Internal Revenue Code.

Accordingly, we at Deere agree with the ERISA Industry Committee that legislation such as H.R. 7263 be enacted to overrule any possible interpretation by the Internal Revenue Service that such plans must conform to the requirements of ERISA in order for an employer to receive a deduction under the Internal Revenue Code for contributions made to such foreign plans.

We, therefore, request that prompt consideration be given to the passage of House Bill 7263.

Very truly yours,

ROBERT A. HANSON, *President.*

DRESSER INDUSTRIES, INC.,
Dallas, Tex., June 25, 1980.

SUBCOMMITTEE ON SELECT REVENUE MEASURES,
Committee on Ways and Means,
U.S. House of Representatives.

GENTLEMEN: Dresser Industries wishes to submit this written statement in support of H.R. 7263, in lieu of personal appearance at the June 26, 1980 public hearings.

Dresser Industries is a large international corporation that furnishes goods and services to the energy and natural resource markets. We presently employ a total of some 13,500 local nationals in our business operations in a host of foreign countries. Many, if not most of these employees, participate in local pension programs developed for such foreign employees.

As you would expect, these foreign pension plans were designed to provide benefits that are appropriate under the prevailing local situation, including local customs, laws, governmental social benefit programs and competitive considerations of the labor market. These local conditions are seldom similar to and often are significantly different from, those prevailing in the U.S.

This fact appeared to be recognized when Congress explicity exempted such foreign programs from the labor and insurance provisions of ERISA when that law enacted. However—we believe essentially through oversight—such an exemption was not included in the tax provisions of ERISA. As a result, Dresser and all other companies with foreign operations are in danger of losing tax deductions for the necessary contributions to these foreign plans, since it would be impractical and sometimes impossible to conform them to ERISA requirements.

If the ERISA requirements are superimposed on all the local legal and operational requirements for each of the plans, it will result in substantial increases in our cost of doing business, either through loss of tax deduction or nonproductive legal and administrative expenses of ERISA compliance. As a result, we would be at competitive disadvantage with foreign business concerns that are not saddied with such costs.

For these reasons, we strongly support enactment of H.R. 7263.

Very truly yours,

JOHN V. JAMES,
Chairman of the Board, President,
and Chief Executive Officer.

EMERGENCY COMMITTEE FOR AMERICAN TRADE,
Washington, D.C., June 25, 1980.

Hon. DAN ROSTENKOWSKI,
Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives.

DEAR MR. CHAIRMAN: The Emergency Committee for American Trade (ECAT) appreciates this opportunity to comment on H.R. 7263, relating to the tax treatment of pension plans maintained overseas for foreign workers by U.S.-based companies. We support H.R. 7263 and request that this letter be made a part of the record associated with the June 26 hearing on that subject.

ECAT is an organization of 64 U.S. companies with extensive international business operations. In 1979, these companies employed nearly 5 million men and women with worldwide sales of $450 billion. Because of our members' great interest and stake in the world marketplace, we are especially sensitive to U.S. government action which could serve to put U.S.-based international companies at a competitive disadvantage.

The need for legislation, such as H.R. 7263, stems from a recent Internal Revenue Service attempt to extend the application of U.S. pension policy to foreign pension plans maintained primarily for the benefit of employees who are nonresident aliens. The IRS has, in effect, ruled that such plans must meet all the tax rules applicable to plans maintained for employees resident in the U.S.

U.S. retirement policy reflected in the Employee Retirement and Income Security Act (ERISA) is a unique combination of American social, historical and economic factors. Other countries, with different circumstances, have taken other approaches to meet their particular national needs. Since these many approaches have produced widely varying national rules in providing retirement security to workers, the IRS attempt, through U.S. international companies, to export U.S. pension rules is potentially disruptive and costly to American business overseas.

H.R. 7263 would treat an employer's liabilities under foreign plans in the same manner as other ordinary and necessary business expenses incurred overseas. Appropriate safeguards would be provided to insure that all deductions reflect true business expenses based on generally accepted U.S. accounting principles.

The Congress has recently been correctly concerned with increasing the competitiveness of U.S. business overseas. Failure to enact H.R. 7263 would result in substantial financial and legal competitive disadvantages to the conduct of business overseas by U.S.-based firms. We thus urge prompt and affirmative action on H.R. 7263.

Sincerely,

ROBERT L. MCNEILL,
Executive Vice Chairman.

EXXON CORP.,
New York, N.Y., July 3, 1980.

Hon. DAN ROSTENKOWSKI,
Chairman, Subcommittee on Select Revenue Measures, U.S. House of Representatives.

DEAR MR. ROSTENKOWSKI: This letter is submitted in conformity with the Press Release No. 17-90/2 dated June 13, 1980, to signify our support of H.R. 7263.

Exxon Corporation, as you know, is a worldwide energy company, and either directly or through its affiliated companies carries on business in most foreign nations, as well as in the United States. Although domestic U.S. tax-qualified retirement plans are maintained for about 75,000 employees and annuitants, approximately 83,000 employees are eligible for and participate in various foreign country retirement plans and arrangements, maintained expressly for their benefit in foreign countries.

Because certain of Exxon's affiliated companies presently employ a substantial number of nonresident aliens at their various foreign locations, these affiliates are currently faced with the prospect of incurring substantial nondeductible costs to maintain pension plans for such employees. One alternative to substantial nondeductible costs would be to obtain U.S. tax-qualified status for these plans, but redesigning the foreign plans to meet the requirements of both U.S. law and foreign law is often difficult and time consuming, frequently resulting in plans that are inconsistent with customary local foreign country practices of long-standing. Further, changing those long-standing arrangements can be disruptive from a labor and employee relations standpoint. An attempt to qualify such foreign plans under U.S. law would at least significantly increase both legal and administrative costs (and in some cases benefit costs) borne by Exxon and its affiliates, and would certainly place the affiliates at a competitive disadvantage vis-a-vis non-U.S. employers who need not accommodate their foreign pension arrangements to U.S. requirements.

We believe that it should be made clear that there is no intention to extend to non-resident aliens employed in other countries those plan requirements contained in the Employee Retirement Income Security Act of 1974 (ERISA), which were intended for U.S. employees. Congress appeared to concur in this view in 1974, when it excluded plans maintained for the benefit of non-resident aliens from Titles I and IV of ERISA.

For these reasons, we strongly support this Bill, and urge that your Subcommittee report out H.R. 7263 favorably at the earliest possible date.

Very truly yours,

RAYMOND A. SCHRODER,
Vice President and Federal Tax Counsel.

GENERAL ELECTRIC CO.,
Fairfield, Conn., June 30, 1980.

Hon. DAN ROSTENKOWSKI,
Chairman, Subcommittee on Select Revenue Measures,
Committee on Ways and Means, Washington, D.C.

DEAR MR. ROSTENKOWSKI: On behalf of General Electric Company, I am writing to advise you of our strong support for H.R. 7263, which would amend the Internal Revenue Code of 1954 with respect to the treatment of retirement and similar plans maintained for nonresident aliens.

The present provisions of the Code, as amended by the Employee Retirement Income Security Act of 1974 (ERISA), have been interpreted by the Internal Revenue Service as preventing U.S. corporations, in some situations, from ever obtaining a business expense deduction for contributions made to provide for pensions under foreign plans. In other situations, involving foreign subsidiaries, pension costs are not allowable as deductions in determniing "earnings and profits," even when such costs are tax deductible under the law of the foreign country, and this can adversely affect the amount of the U.S. parent corporation's foreign tax credits.

H.R. 7263 recognizes that it is neither necessary nor desirable to apply the strict rules of U.S. tax law to plans maintained abroad for nonresident aliens and eliminates the unintended hardship imposed by ERISA on U.S. corporations maintaining such plans.

Therefore, we strongly urge your Subcommittee to recommend to the full Ways and Means Committee that it act promptly and favorably on this much needed legislation.

We request that this letter be included in the printed record of the June 26 hearing.

Very truly yours,

J. J. COSTELLO,
Vice President-Comptroller.

THE GILLETTE CO.,
Boston, Mass., July 1, 1980.

SUBCOMMITTEE ON SELECT REVENUE MEASURES,
Committee on Ways and Means,
U.S. House of Representatives,
Washington, D.C.

GENTLEMEN: The Gillette Company would like to submit a written statement in lieu of a personal appearance at the public hearing scheduled for June 26, 1980. The Gillette Company urges enactment of H.R. 7263.

The Gillette Company is a Delaware corporation with its principal office at the Prudential Tower Building, Boston, Massachusetts. Its stock is widely held and is traded on the New York, Boston, Midwest, Pacific and various foreign stock exchanges. The Gillette Company is primarily engaged in the business of manufacturing and selling blades and razors, shaving creams, writing instruments, shampoos, toiletries, cigarette lighters, and other products and services. It controls a number of domestic and foreign subsidiaries which are engaged, in whole or in part, in businesses similar to those conducted by the Company and employs approximately 33,900 people, 24,700 of which are outside of the United States.

The Gillette Company maintains pension plans for employees at certain foreign locations. The plans comply with the requirements of foreign laws and are maintained according to sound actuarial principles. The effort by the Internal Revenue Service to deny deductions for foreign pension plans unless such plans meet the requirements of the Employee Retirement Income Security Act is equivalent to imposing U.S. policy regarding pension administration upon foreign pension plans governed by foreign law. Indeed, the requirements of the Employee Retirement Income Security Act may be contrary to the policies of the foreign government and meeting the U.S. requirements may be difficult and costly, if not impossible.

On the other hand, under the current Internal Revenue Service position, failure to meet the requirements of ERISA can have the effect of cancelling a deduction authorized by foreign law.

Accordingly, we strongly endorse H.R. 7263 and urge that you report this Bill favorably at the earliest opportunity so that the uncertainties that now prevail regarding the taxation of foreign pension plans may be eliminated.

Very truly yours,

ROBERT F. SAMA, *Tax Counsel.*

STATEMENT OF MICHAEL J. DOYLE, DIRECTOR OF GOVERNMENTAL AFFAIRS, THE HANNA MINING CO., CLEVELAND, OHIO

The Hanna Mining Company is one of the world's leading iron ore mining companies and in Canada we are a partner in the Iron Ore Company of Canada (IOC), an American company doing business in Canada. IOC employs over 7200 people. Virtually all of them are Canadian citizens. The total yearly contribution to the IOC pension program is $9.4 million.

The I.R.S. will not allow deductions with respect to foreign defined benefit plans which do not meet U.S. standards for U.S. pension plans as set forth in our recently enacted Employee Retirement Income Security Act (ERISA).

In such cases as ours, where the U.S. company's primary place of business is outside the country and virtually all of its employees are citizens of that foreign country, it would appear appropriate that minimum pension standards different than those provided for in ERISA would be an appropriate and reasonable expression of public policy.

In our case as well as most others, our Canadian workers are well represented by the United Steelworkers of America and are quite capable of protecting their members interests in pension negotiations.

Passage of H.R. 7263 would enable us to claim our pension contribution as a valid business expense. Certainly no one can argue that pension costs are not an expense of doing business and we believe we are being unfairly discriminated against by being denied a tax deduction merely because our Canadian pension negotiations take a different form than that deemed the ultimate by ERISA. Certainly our Canadian competitors are receiving a business deduction for their pension contributions, thus imposing an unfair burden on our Canadian operation merely because its corporate form is as a U.S. company. We do not believe public policy is well served by imposing U.S. standards on business matters taking place outside the territorial limits of the United States.

We therefore wish to express our support for the principles expressed in H.R. 7263 and strongly urge the subcommittee to report the bill out favorably at the earliest possible date.

PHILLIPS PETROLEUM CO.,
Bartlesville, Okla., June 25, 1980.

SUBCOMMITTEE ON SELECT REVENUE MEASURES,
Committee on Ways and Means,
U.S. House of Representatives.

GENTLEMEN: This letter is in lieu of our appearance at the public hearing before your committee scheduled for June 26, 1980. Phillips Petroleum Company supports enactment of HR 7263. Our Company has over 30,000 employees engaged in oil exploration and production, manufacturing and marketing activities in many parts of the world.

We have approximately 4,000 non-U.S. employees covered by pension-type plans in 23 foreign countries. These plans are designed to comply with local laws and competitive practices. We encounter considerable expense in funding these plans without benefit of an appropriate deduction on our U.S. income tax return. This places U.S. companies at a disadvantage with local competition who are not subject to U.S. tax.

Generally speaking, we would have to redesign most of these plans to comply with ERISA in order to obtain a U.S. tax deduction. This would entail substantial cost and many man months of specialized talent to make sure the changes to comply with the U.S. law did not violate or contradict a local law. The end result would be plans that are inconsistent with local foreign practices.

We strongly endorse this bill and urge your subcommittee to report out the bill favorably at your earliest convenience.

W. R. THOMAS.

PRICE WATERHOUSE & Co.,
Washington, D.C., July 3, 1980.

Congressman DANIEL ROSTENKOWSKI,
Chairman, Subcommittee on Select Revenue Measures,
Washington, D.C.

DEAR MR. ROSTENKOWSKI: We are pleased to have the opportunity to express our support for passage of H.R. 7263, introduced by Representative Conable, which was considered by your subcommittee at public hearings on June 26, 1980. The bill proposes to amend the Internal Revenue Code as it applies to nonqualified deferred compensation plans for nonresident aliens. It is designed to remedy certain problems which, in part, accrue to U.S. taxpayers as a result of an apparent oversight of The Employee Retirement Income Security Act of 1974 (ERISA).

THE BILL

The bill would provide special rules regarding allowance of U.S. tax deductions for nonqualified (under U.S. law) deferred compensation plans maintained for the primary benefit of nonresident aliens. It would also provide special rules for determination of earnings and profits of certain foreign companies having nonqualified deferred compensation plans, and special rules for foreign trusts created by U.S. grantors which do not explicitly prohibit benefit payments to U.S. taxpayers.

The first two provisions of the bill would permit both foreign branch operations of U.S. companies, and certain foreign companies, to use rules which would approximate accrual basis rules for nonqualified deferred compensation plans. These rules would cover plans where substantially all of the participants are nonresident aliens. The net result would be to allow taxable income in the case of branches, and earnings and profits in the case of subsidiaries to be reduced by taking into consideration a company's obligation to a deferred compensation agreement by reference to the accrual method of tax accounting, provided the obligation is fixed and determinable without regard to whether a separate fund is established.

The bill provides for four requirements must be met in order to secure an accrual basis deduction. These rules follow:

1. The benefits provided by the plan must be either required by foreign law or set forth in a written document communicated to the active participants;
2. For defined benefit plans, the deduction is limited to amounts paid or accrued in respect of benefits that are reasonably capable of actuarial estimation;
3. The actuarial cost method and assumptions used must, in the aggregate, be reasonable to the extent the amount taken into account is dependent upon actuarial determinations; and
4. The amount to be taken into account for a taxable year must be determined in a manner consistent with generally accepted United States accounting principles applicable to the charging of pension costs against income.

These and other specific rules included in the bill will assure that enactment would not result in taxpayer abuse.

BACKGROUND AND NECESSITY FOR LEGISLATION

Many U.S. companies which do business outside of the United States maintain deferred compensation plans for the benefit of nonresident aliens working in foreign locations. Foreign employee benefits under deferred compensation plans often mirror benefits provided to the U.S. company's employees based in the U.S. In some instances deferred compensation plans covering foreign employees are entered into voluntarily and in other circumstances the deferred compensation arrangements are proscribed by foreign law. It is typical for U.S. companies operating outside of the United States to carry on business either through foreign subsidiaries or branch offices of United States' companies. Typically a substantial portion of the participants in the foreign deferred compensation plans are nonresident aliens.

Many of the foreign countrys' rules, applying to the deferred compensation plans in question, differ markedly from the rules applied to similar plans in the United States. Consequently, the operative rules, including those involving tax law, which apply to foreign and domestic deferred compensation plans differ significantly, without regard to benefits or coverage. For example, a common trait of a U.S. pension or similar benefit plan is funding through a trust vehicle. Such funding is not typical in many foreign jurisdictions. To the contrary, current funding of deferred compensation arrangements through a trust medium is discouraged in some countries. In certain instances current funding through a trust has a detrimental effect on the foreign employee. It is clear that payments under deferred compensation agreements, whether applying to domestic or foreign situations, are ordinary and necessary in the business context.

The enactment of ERISA in 1974 substantially changed the rules regarding the operations of deferred compensation plans, including U.S. tax deductibility of payments made under such plans. Provisions of this Act differ significantly from those of most foreign countries. Practice has shown it to be difficult, if not impossible, for most U.S. employers to conform deferred compensation plans covering nonresident alien employees of either a branch or foreign subsidiary to requirements of ERISA and the rules of the host foreign country.

The Internal Revenue Service has recently made it clear in a private letter ruling and a technical advice momorandum, that a company's foreign deferred compensation plans must conform to U.S. rules in order to secure desired U.S. tax benefits. While the position of the Internal Revenue Service may be well founded by reference to the rules under ERISA, dual compliance is impossible in many situations.

The private letter ruling concerned the deductibility by U.S. corporations having a foreign branch. In this ruling it was held that contributions to a pension trust were not deductible for U.S. income tax purposes, at either the time that they were paid to the trust or at the time the benefits were actually paid to the employees. The technical advice memorandum concerned determinations of a foreign subsidiary's earnings and profits. Here the IRS concluded that foreign subsidiaries cannot take accrued pension plan liabilities into consideration in determining earnings and profits for U.S. tax purposes.

There is some evidence that these rulings indicate an unintended result of the 1974 legislation. The provisions of H.R. 7263 would assure that these unintended results do not continue.

EFFECTIVE DATES

H.R. 7263 does not specify effective dates for various of its provisions, which for certain of these provisions are important.

It appears that the question regarding U.S. income tax deductibility of payments made under deferred compensation arrangements covering nonresident alien employees of a foreign branch of a U.S. company, arose as a result of the enactment of ERISA. It therefore seems appropriate to relate the effective date of this provision to the date of ERISA's enactment.

It is less clear that the question regarding the impact of payments made under nonqualified deferred compensation arrangements of foreign subsidiaries traces back to the enactment of ERISA. With this in mind, an effective date applied to all past years of a foreign subsidiary would seem appropriate with a view toward avoiding prolonged litigation.

SUMMARY

Enactment of H.R. 7263 would be a positive step toward resolving what appears to be an unintended U.S. tax result arising from ERISA, which was enacted with a primary view toward controlling administration and operation of deferred compensation plans as they apply to U.S. taxpayers and their U.S. employees. Further, enactment would relieve both the private sector and the public sector from the extreme burden of determining whether foreign deferred compensation plans qualify under ERISA and the applicable rules of the foreign host country. Finally, enactment would enable the U.S. business community to plan appropriately for the continued use of foreign deferred compensation plans.

Yours very truly,

PETER J. HART,
National Director of Tax Policy.

R. J. REYNOLDS INDUSTRIES, INC.,
Winston-Salem, N.C., July 2, 1980.

SUBCOMMITTEE ON SELECT REVENUE MEASURES,
Committee on Ways and Means,
U.S. House of Representatives

GENTLEMEN: This written statement is in lieu of personal appearance at the public hearing before your committee scheduled for June 26, 1980. R. J. Reynolds Industries supports the enactment of H.R. 7263.

R. J. Reynolds is engaged through subsidiaries and branches in the domestic and international manufacture and sale of tobacco products, foods and beverages, transportation, energy and packaging products. As of December 31, 1979 R. J. Reynolds Industries had approximately 79,500 regular employees. Principal subsidiaries are located in Canada, the United Kingdom, Germany, the Netherlands, Puerto Rico, West Germany, the Philippines, Panama, Costa Rica, Guatemala, Liberia, Mexico, Kenya, and Bermuda with minor subsidiaries in numerous other countries. Branches of Sea-Land Service, Inc., our shipping subsidiary, are located in more than 50 foreign countries.

RJR employs a substantial number of non-resident aliens at our numerous foreign locations. A large number of these employees are included in foreign pension plans. Because of the uncertainty in the law, we are faced with the possibility of incurring substantial nondeductible costs in order to maintain these plans.

Meeting the requirements of both U.S. and foreign law is a complex, difficult task that frequently results in plans that are inconsistent with customary foreign local practices. The circumstances produced by inconsistent U.S. and foreign law has in some cases increased our benefit costs, placing us at a competitive disadvantage.

We believe that no justifiable social purpose is served by extending to non-resident aliens the protections contained in ERISA which were designed for U.S. employees. Congress appeared to concur in this judgment in 1974 when it excluded plans maintained primarily for the benefit of nonresident aliens from Title I and IV of ERISA.

We therefore strongly endorse the subject bill and urge your subcommittee to report out this bill favorably at the earliest possible date.

Very truly yours,

M. J. MURPHY,
Director-International Taxation.

SEARS, ROEBUCK & CO.,
Chicago, Ill., June 27, 1980.

Hon. DAN ROSTENKOWSKI,
Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives.

DEAR MR. CHAIRMAN: Sears, Roebuck and Co. recommends that the Subcommittee on Select Revenue Measures report H.R. 7263 favorably. This would remove the bias favoring unfunded pension plans covering nonresident alien employes of domestic employers.

Sears maintains pension plans in seven foreign jurisdictions, covering nationals who are residents in such foreign jurisdictions. All of the foreign pension plans are typical pension plans under the local laws and customs.

Because of the specific statutory requirements for qualification under ERISA, it is doubtful that any of these plans could qualify under ERISA if they were funded, even though all of them would comply with the laws of the local jurisdictions. Section 4(b)(4) of ERISA exempts a foreign pension plan maintained outside the U.S. primarily for the benefit of nonresident aliens from coverage under Title I of ERISA. However, a funded plan is not exempt under Title II and therefore, employer contribution deductions are subject to the provisions of Section 404 of the Internal Revenue Code.

If Sears foreign pension plans were funded, Sears would never obtain a U.S. tax deduction for contributions to or payments from the foreign pension trusts. Section 404(a)(5) of the Code will allow a tax deduction only if a separate account is maintained for each employe. Under a typical pension plan, separate accounts are never maintained for each employe. Further, if a foreign trust were set up, Section 679 of the Code would appear to treat Sears as the owner of the property and taxable on all income earned by the trust.

In view of the foregoing, a domestic employer who wishes to grant pension coverage to its nonresident alien employes is discouraged from using a funded pension arrangement.

Sears urges the Subcommittee to report H.R. 7263 favorably in order to remove the bias for maintaining unfunded plans. In many instances, employers wish to maintain funded plans in order to fix their liability annually, especially in view of the fluctuating foreign exchange rates. Passage of H.R. 7263 will enable employers to satisfy this objective.

Sincerely,

Raymond P. Bilger,
Vice President, Taxes.

Sperry Corp.,
New York, N.Y., June 30, 1980.

Hon. Dan Rostenkowski,
Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives.

Dear Mr. Chairman: It has come to our attention that the Internal Revenue Service is requiring that ERISA Forms 5500 be filed with respect to foreign retirement plans maintained by U.S. persons for nonresident aliens if a deduction is claimed for contributions and that it has taken the position in private letter ruling 7904042 that a U.S. employer may deduct contributions to a foreign plan only if that plan is a fully qualified plan pursuant to the Internal Revenue Code as amended by Title II of ERISA.

In view of the fact that such foreign plans are currently exempt from meeting the standards set forth in Title I of ERISA, we strongly urge the adoption of H.R. 7263 in order to correct the oversight in ERISA, if such be the case, by conforming the Internal Revenue Code to Title I of ERISA.

In support of our position, we point to the following:

1. In view of the private letter ruling 7904042, supra, it seems possible that the Internal Revenue Service may literally attempt to apply the Code so as to tax employers on the income from trusts which are a part of "nonqualified" foreign plans under IRC Section 679.

2. Imposition of U.S. Standards on foreign plans maintained for nonresident aliens presents insurmountable problems such as:

a. *Canada*—Canadian law requires a plan member to be given the option to elect a joint and survivor annuity, whereas IRC Section 401(a)(II), as added by ERISA, requires that the employee must have the benefit unless he elects otherwise.

b. Technical advice memorandum 7839005 (IRS) deals with the practice in Germany of funding plans through reserve accounts. Trusts are uniquely a concept of English common law that is not recognized in Germany and other countries.

c. Jamaican authorities have objected to plans which incorporate provisions required by ERISA.

Respectfully submitted,

Kenneth F. Crafts,
Manager, Pension Analysis and Research.

STANDARD OIL CO. (INDIANA),
Chicago, Ill., June 30, 1980.

SUBCOMMITTEE ON SELECT REVENUE MEASURES,
Committee on Ways and Means,
U.S. House of Representatives.

DEAR SIRS: Pursuant to your Notice of Hearing on Minor Tax Bills, dated June 13, 1980, this letter is intended as a written testimony in support of H.R. 7263, a Bill to amend the Internal Revenue Code of 1954 with respect to the treatment of retirement and similar plans maintained for nonresident aliens.

The problem presented to the Subcommittee arises, for example, when a U.S. corporation operating abroad establishes a pension plan for its foreign national employees. As a U.S. corporation, the company files both U.S. and foreign income tax returns, and seeks to deduct its contributions to the plan in both returns. Although the plan satisfies the requiremnts of the foreign government for a foreign tax deduction, it will not qualify for a U.S. tax deduction (according to the Revenue Service) unless the plan is conformed to ERISA requirements.

In brief, H.R. 7263 resolves the problem by permitting such U.S. deduction within broad safeguards and without regard to ERISA requirements. This exceptional treatment would be applied only to contributions to plans maintained primarily for foreign nationals. We support the Bill for the following reasons:

1. The problem arises from a legislative oversight in the 1974 enactment of ERISA. On the Department of Labor side, ERISA exempts plans for foreign nationals from its requirements by special provision. The tax treatment was intended to be consistent but Congress assumed erroneously that this could be achieved without a special provision in the Internal Revenue Code.

2. Experience has shown that foreign national employees are oriented to plan benefits different from typical U.S. patterns. Amending a plan for foreign nationals to comply with U.S. concepts could create foreign labor problems.

3. The burden of convincing a foreign government to conform to U.S. requirements involves long delays and uncertainty. Before a U.S. company can approach a foreign government, it must first know what constitutes an ERISA-approved plan. Although ERISA was generally effective in 1976, it was not until 1978 that this company had secured its first IRS approval. This approval was based on guidelines and proposed regulations which were later finalized in 1979, requiring another IRS approval in 1979. Many years may pass, therefore, before a U.S. company can even inform a foreign government what must be done to make plan contributions deductible in both countries.

4. The burden of keeping the plan in current compliance in two countries is intolerable. There are annual changes in U.S. law and regulations (such as ADEA) which must be presented for IRS approval and then agreed to by the foreign government. If the foreign government will not accept the changes verbatim, there is the problem of inducing the IRS to accept the foreign country modifications. This can be an endless cycle back and forth.

5. Foreign governments are often hostile to the imposition of U.S. rules as a matter of sovereignty. One major foreign country has insisted that the foreign plan be divided into two plans, one consisting of provisions acceptable without revision to both governments, and one consisting of provisions acceptable only to the foreign goverment. This solution is generally unworkable but it illustrates the reluctance of certain foreign governments to revise their plans to accommodate U.S. taxpayers.

We urge you, therefore, to give favorable consideration to H.R. 7263 as a means of correcting an oversight in the ERISA legislation and of curing an unreasonable disallowance of tax deductions.

J. J. GOBEL,
Chief Tax Counsel.

UNITED STATES STEEL CORP.,
Pittsburgh, Pa., June 27, 1980.

Hon. DAN ROSTENKOWSKI,
Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives.

DEAR MR. CHAIRMAN: This is to advise that we support H.R. 7263 amending the Internal Revenue Code of 1954 with respect to the treatment of retirement and similar plans maintained for nonresident aliens.

We strongly urge that prompt Congressional consideration be given to this bill which in a welcome measure conforms the treatment for these plans under the Code to the existing exemption of such plans from Title I of the Employee Retirement Income Security Act of 1974 (ERISA).

Deductions to retirement plans maintained by United States persons for nonresident aliens should not depend upon whether the plan meets ERISA standards. It is quite common for U.S. domestic corporations to do business in one or more foreign countries through branch offices or subsidiaries with nonresident alien employees. In view of conflicting tax or social security law requirements and/or competitive employment factors, the adoption of separate employee benefit plans for these groups of employees is a practical consideration and in some instances a necessity. The administrative problems and expense inherent with maintaining U.S. tax qualification status under dual national tax requirements for retirement plans for small groups of such employees is prohibitive.

If a foreign pension plan is not qualified under Section 401(a) of the Code, there are many instances when a U.S. taxpayer is forever denied a deduction for contributions to or payments out of the foreign pension trust. Section 404(a)(5) of the Code provides that contributions to a non-qualified trust are deductible when they are includible in the gross income of the employees, but only if the plan is a separate account plan. Since most pension plans are not separate account plans, no deduction is ever available.

Plans "maintained outside the United States primarily for the benefit of persons substantially all of whom are nonresident aliens" are exempt by section 4(b)(5) of ERISA from al requirements of Title I of ERISA. There is, however, no parallel provision in the Code. We submit that had Congress had the time to focus adequately on the matter, such plans would have been exempted from the ERISA amendments to the Code. This belief is based on the ERISA Conference Report suggesting that the Code does not exempt foreign plans from the ERISA standards because "such plans would have no need to seek tax deferral qualification". H.R. Rep. 93–1280, 93d Cong., 2d Sess. 291 (1974). This analysis is at best, incomplete; it ignores the problems of deduction of contributions to foreign plans and of taxation to U.S. employers of the income of such plans and the fact that foreign plans often cannot comply with the ERISA requirements.

There can be no question that a U.S. employer should be able to deduct the cost of foreign pensions at some point. H.R. 7263 assures that contributions to foreign plans would be deductible under the conditions it specifies and it should be favorably acted upon by the Congress at the earliest possible moment.

Five copies of this statement are submitted herewith for consideration by your Committee.

Respectfully submitted,

Roy G. Gourley,
Tax Administrator.

William M. Mercer, Inc.,
New York, N.Y., June 26, 1980.

Subcommittee on Selected Revenue Measures,
Committee on Ways and Means,
U.S. House of Representatives.

Gentlemen: This letter is to affirm our strong support for H.R. 7263.

William M. Mercer, Incorporated is the nation's largest employee benefit plan consulting firm. Included among our clients are several hundred companies which maintain directly or through subsidiaries retirement benefit programs on behalf of employees who are employed in countries throughout the world. The number of such plans run into the thousands.

We are extremely concerned over the rigid, literal construction by the Internal Revenue Service of present Section 404(a)(4) of the Internal Revenue Code. Enforcement of tihs construction would undermine the tax relief previously available under Code Section 404(a)(4) on account of contributions paid or accrued under such retirement benefit plans for foreign employees. Tax relief would be available only if such foreign plan reflected the provisions of the Employee Retirement Income Security Act (ERISA). As a practical matter this would entail the exporting of U.S. retirement plan standards and practices. In some countries, this requirement would be contrary to local law so that the effort to accomplish U.S. tax relief would mean the loss of local tax relief, thereby defeating the point of the exercise.

In other countries, the design and practices involved in plans for U.S. employees are neither practical nor desired, and in some instances make no sense whatever.

Adoption of H.R. 7263, by restoring the assurance of tax relief which prevailed for so many years before ERISA, may fairly be categorized as a triumph for commonsense. In our view, it reenacts the original intent of Congress to extend tax relief for amounts paid or accrued for foreign-based retirement plans.

Sincerely,

LLOYD S. KAYE,
Vice President.

H.R. 7276

A BILL To amend the Internal Revenue Code of 1954 to allow the investment tax credit for certain rehabilitated buildings leased to tax-exempt organizations or to governmental units

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) paragraph (4) of section 48(a) of the Internal Revenue Code of 1954 (relating to property used by certain tax-exempt organizations) is amended by adding at the end thereof the following new sentence: "This paragraph shall not apply to any property which is treated as section 38 property by reason of paragraph (1)(E) of this subsection and which is used by the tax-exempt organization pursuant to a lease."

(b) Paragraph (5) of section 48(a) of such Code (relating to governmental units) is amended by adding at the end thereof the following new sentence: "This paragraph shall not apply to any property which is treated as section 38 property by reason of paragraph (1)(E) of this subsection and which is used by the governmental unit pursuant to a lease."

(c) The amendments made by this section shall apply to taxable years ending after October 31, 1978.

SUMMARY

Present law

The Revenue Act of 1978 extended the investment tax credit to rehabilitation expenditures incurred in connection with existing buildings used in all types of business or productive activities except those, such as apartments, which are used for residential purposes. Eligible buildings include factories, warehouses, office buildings, hotels, and retail and wholesale stores.

To qualify as a rehabilitation expenditure, the expenditure must be incurred after October 31, 1978, in connection with the rehabilitation or reconstruction of a building which has been in use for a period of at least 20 years before the commencement of the rehabilitation.

Under present law (Code secs. 48(a) (4) and (5)), property owned by or leased to a tax-exempt organization (other than use in an unrelated trade or business) or by a governmental unit is not qualified for the investment tax credit.

The Technical Corrections Act of 1979 (Public Law 96–222) provided an exception to the rules designed to deal with certain equipment leasing tax shelters (under these rules property subject to a net lease is ineligible for the credit if the lessor is a noncorporate lessor). This exception was provided to accommodate the traditional and customary use of net lease arrangements for buildings.

Issue

The issue is whether the investment tax credit should be allowed in the case of rehabilitated buildings leased to tax-exempt organizations and governmental units.

Explanation of the bill

The bill would make the present exception denying the credit for property used by a tax-exempt organization or governmental unit inapplicable in the case of qualified rehabilitation expenditures to rehabilitate existing buildings.

Effective date

The bill would be effective for taxable years ending after October 31, 1978.

Revenue effect

The revenue estimate for this bill is not yet available.

Statement of the National Realty Committee, Inc.

The National Realty Committee, Inc., a nonprofit business league whose membership includes owners, operators and developers of all types of real estate throughout the United States, offers the following statement, in support of H.R. 7276, for consideration and action by the House Ways and Means Subcommittee on Select Revenue Measures.

Prior to extension of the investment credit to expenditures for "qualified rehabilitated buildings" enacted as part of the Revenue Act of 1978, the investment credit provisions were generally inapplicable to commercial real estate. Accordingly, the investment credit statutory scheme, including peripheral limitations on the availability of the credit, was enacted with reference to typical equipment leasing transactions. The extension of the credit to qualified rehabilitations of commercial real estate makes an examination of the applicability of those peripheral provisions to commercial real estate an important undertaking.

PROPERTY USED BY TAX EXEMPT AND GOVERNMENT ENTITIES

Code Sections 48(a) (4) and (5) deny the availability of the investment credit to property used by organizations exempt from income tax (except if predominantly used in a taxable business), or used by the United States, any state or local government, and any international organization. Thus, under present law, the credit is not available if any such organization or entity is either the owner or lessee of otherwise eligible property.

The application of this limitation to commercial rental property could effectively eliminate government and non-taxable entities as potential tenants in buildings where the owner has either made or plans to make rehabilitation expenditures. For some buildings, particularly downtown office buildings in areas where tax-exempt and government entities comprise a significant part of the potential market for leased space, the limitation could eliminate any incentive for rehabilitation provided by the investment credit. This would clearly frustrate the congressional objective of providing special encouragement for the rehabilitation of older buildings.

Moreover, the original congressional purpose in enacting the limitations of Code Sections 48(a) (4) and (5) would be substantially exceeded by applying it to otherwise creditable rehabilitations. The purpose of the limitations in Sections 48(a) (4) and (5) was to prevent the use of the investment tax credit for tax-shelter transactions in which users of equipment who were exempt from income tax would lease equipment from taxable lessors.

Business equipment is customarily purchased by the intended user. A decision by a non-taxable user to lease equipment rather than to purchase is generally a financing decision. Transfer of the investment tax credit and other tax benefits arising from the ownership of the property to a taxable lessor, in effect, would permit the non-taxable user to acquire the equipment at a lower net cost than would be incurred by direct acquisition.

This is in contrast to the case of commercial rental real estate, in which the owner of the property is customarily not the user. The actual use of the real estate by tenant-lessees, rather than by the owner, is inherent in the nature of the asset involved. It is not merely a financing decision to traffic in the benefits of the investment credit. Unlike the case of a lessor who leases equipment to non-taxable users on a long-term basis, the practical ownership, control and risk of a rehabilitated building generally reside in the person incurring the rehabilitation expense. Therefore, the congressional purpose underlying Code Sections 48(a) (4) and (5) has very limited, if any, applicability to creditable rehabilitations of commercial real property.

In addition to unnecessarily diminishing the incentive for rehabilitating commercial rental property, the application of Sections 48(a) (4) and (5) to commercial real estate could create several complications. An owner who has made qualifying rehabilitation expenditures and obtained an investment credit may find that a tenant has subsequently subleased a portion of the space to a proscribed subtenant, causing the owner to be treated as having made a disposition of the rehabilitated property to the extent of the subleased space. This could result in recapture of a portion of the owner's investment credit, even though the owner was not a party to the sublease.

Finally, leasing a portion of a building to a proscribed tenant could cause substantial allocation problems in ascertaining the portion of the total qualified rehabilitation expenditure attributable to the space leased to the proscribed tenant. A distinction between typical real property situations and the equipment leasing transactions to which Code Sections 48(a) (4) and (5) was intended to apply, is the multiplicity of leases usually present in the case of real property. Unlike the equipment leasing transaction, in which the creditable property, i.e., the equipment, is leased to a single lessee, rehabilitated commercial real property will often be leased to a number of tenants under a variety of leases.

The existence of multiple leases with varying terms in a commercial rental building makes application of the limitation extremely cumbersome, in comparison to the leasing of a single item of depreciable personalty. Accordingly, if Sections 48(a) (4) and (5) are to be applicable to real property transactions, complicated and arbitrary allocation rules will inevitably be needed to determine which rehabilitation components are leased to taxable and which to non-taxable tenants. The allocation process will be difficult because the portion of the building benefited by those components, as well as the periods of the different leases, can vary substantially within a single building.

In short, the National Realty Committee believes that exempting otherwise creditable rehabilitation expenditures from the limitations of Code Sections 48(a) (4) and (5) is consistent with and necessary to effectuate fully the purpose of Congress in extending the investment credit to rehabilitations of eligible buildings.

H.R. 7318

A BILL To amend section 170 of the Internal Revenue Code of 1954 to revise and make permanent the provisions for allowing a deduction for contributions for conservation purposes

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) paragraph (3) of section 170(f) of the Internal Revenue Code of 1954 (relating to denial of deduction in case of certain contributions of partial interest in property) is amended by striking out subparagraph (B) thereof and inserting in lieu thereof the following new subparagraph:

"(B) EXCEPTIONS.—Subparagraph (A) shall not apply to—

"(i) a contribution of a remainder interest in a personal residence or farm,

"(ii) a contribution of an undivided portion of the taxpayer's entire interest in property, and

"(iii) a qualified conservation contribution."

(b) Section 170 of such Code is amended by redesignating subsections (h) and (i) as subsections (i) and (j), respectively, and by inserting after subsection (g) the following new subsection:

"(h) QUALIFIED CONSERVATION CONTRIBUTION.—

"(1) IN GENERAL.—For purposes of subsection (f)(3)(B)(iii), the term 'qualified conservation contribution' means a contribution—

"(A) of a qualified real property interest,

"(B) to a qualified organization,

"(C) exclusively for conservation purposes.

"(2) QUALIFIED REAL PROPERTY INTEREST.—For purposes of this subsection, the term 'qualified real property interest' means any of the following interests in real property:

"(A) the entire interest of the donor other than a qualified mineral interest,

"(B) a remainder interest, and

"(C) a restriction granted in perpetuity on the use which may be made of the real property.

"(3) QUALIFIED ORGANIZATION.—For purposes of paragraph (1), the term 'qualified organization' means an organization—

"(A) which is described in clause (v) or (vi) of subsection (b)(1)(A), or

"(B) which is described in section 501(c)(3) and meets the requirements of section 509(a)(2).

"(4) EXCLUSIVELY FOR CONSERVATION PURPOSES.—For purposes of this subsection—

"(A) CONSISTENT USE PERMITTED.—A contribution shall not be treated as not made exclusively for conservation purposes merely because the real property may be used for another purpose which is consistent with the conservation purpose.

"(B) NO SURFACE MINING PERMITTED.—In the case of a contribution of any interest where there is a retention of a qualified mineral interest, the conservation purpose test shall be treated as met if extraction or removal of minerals is permitted only by other than surface mining methods.

"(5) QUALIFIED MINERAL INTEREST.—For purposes of this subsection, the term 'qualified mineral interest' means—

"(A) subsurface oil, gas, or other minerals, and

"(B) the right to access to such minerals."

(c) The amendments made by subsections (a) and (b) shall apply to transfers made after the date of the enactment of this Act in taxable years ending after such date.

SEC. 2. Section 309(b)(1) of the Tax Reduction and Simplification Act of 1977 and section 2124(e)(4) of the Tax Reform Act of 1976 are each amended by striking out ", and before June 14, 1981."

SUMMARY

Present law

As a general rule, a deduction is not allowed for income, estate, and gift tax purposes for contributions to charity of less than the taxpayer's entire interest in the contributed property. This restriction was enacted by Congress in the Tax Reform Act of 1969 to prevent certain tax-avoidance transactions in which the taxpayer could obtain a deduction for a gift to a charity of the use of part of his property. Exceptions allowing deductions for charitable contributions of partial interests in property are provided for the contribution of (1) a remainder interest in a personal residence or farm; (2) an undivided portion of the taxpayer's entire interest in the property; (3) cetain interests in trust; and (4) interests not transferred in trust that would be deductible if made in trust (Code secs. 170(f), 2055(e)(2), and 2522(c)(2)). The Conference Report on the Tax Reform Act of 1969 states that a gift of an open space easement in gross is to be considered a gift of an undivided interest in property where the gift is in perpetuity. On the basis of that Conference Report language, the Internal Revenue Service has allowed deductions for contributions of certain kinds of easements under the undivided interest exception including open space, historical, and recreational easements. Rev. Rul. 74–583, 1974–2 C.B. 80; Rev. Rul. 75–358, 1975–2 C.B. 76; Rev. Rul. 75–373, 1975–2 C.B. 77.

However, explicit statutory exceptions for charitable contributions made "exclusively for conservation purposes" were provided in Tax Reform Act of 1976 (and modified by the Tax Reduction and Simplification Act of 1977). Under these exceptions, a deduction is permitted for the contribution to a charitable organization for conservation purposes of (a) a lease on, option to purchase, or easement with respect to real property granted in perpetuity or (b) a remainder interest in real property. (Code secs. 170(f)(3)(B) (iii) and (iv).) The exceptions for these partial interests contributed for conservation purposes only apply to contributions made before June 14, 1981.

Issues

Issues raised by the bill include the following:

(1) Should a deduction be allowed after June 13, 1981, for contributions of partial interests in real property made exclusively for conservation purposes?

(2) Should the eligible recipients of conservation contributions be limited to certain publicly supported charitable organizations and governmental units?

(3) Since the value to the public of a conservation easement lies in the restrictions it places on the donor's use of the retained property (because, unlike most types of property contributed to charity, an easement cannot, as such, be used by the charity), should a deduction be allowed for the contribution of an easement only where the restrictions imposed by the easement serve some public benefit and are likely to be enforced?

(4) Should the owner of property that may have subsurface oil and gas or other minerals, or property that is actively used for the extraction of oil and gas or other minerals, be permitted a deduction for contributing the fee interest while retaining all rights to extract the oil and gas or other minerals through nonsurface extraction methods?

(5) Should the definition of conservation purposes be broadened to include the preservation of "open space" or farmland where such preservation is consistent with a defined governmental policy (an important issue in light of the uncertainty as to whether a gift of an open space easement qualifies for a deduction under present law as a gift of an undivided interest)?

(6) Should the definition of historically important land areas or structures in section 170(f)(3)(C)(ii) be more closely coordinated with the National Register and with the related provisions of the Code allowing rapid amortization of expenditures incurred in rehabilitating certified historic structures (sec. 191(d))?

(7) Should rules be provided for situations where a transferred partial interest in real property, for which a deduction was allowed because it served a conservation purpose, ceases to be used in furtherance of the conservation purpose?

Explanation of the bill

The bill would revise present Code provisions allowing deductions for charitable contributions of easements and other partial interests in real estate contributed for conservation purposes. In addition, these provisions, which are to expire on June 14, 1981, would be extended for future years without any later sunset date.

The bill would allow a deduction for the contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. Under the bill, a qualified real property interest would be (1) the entire interest of the donor in the real property, other than a qualified mineral interest; (2) a remainder interest; or (3) a restriction granted in perpetuity on the use which may be made of the real property. A qualified mineral interest would be subsurface oil, gas, or other minerals and the right to access to such minerals. If, however, the minerals retained may be removed or extracted by surface mining methods, then the gift would not be a qualified conservation contribution. In general, a qualified organization would be a governmental unit or a publicly supported charitable organization.

Effective date

The provisions of the bill (other than section 2 relating to the repeal of the June 14, 1981, sunset date for Code secs. 170(f)(3)(B) and (C)) would apply to transfers made after the date of enactment in taxable years ending after such date.

Revenue effect

It is estimated that this bill would reduce fiscal year receipts by $5 million annually.

STATEMENT OF HON. JOSEPH L. FISHER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF VIRGINIA

Mr. Chairman, I would like to thank the Committee for giving me an opportunity to present my views on H.R. 7318. Last year Congressmen John Dingell and Andy Jacobs introduced legislation, H.R. 4611, which sought to make two changes in current tax law. First, it would have removed the June 14, 1981 termination date for the deductibility of easements for conservation purposes. Second, it would have allowed for a donation of land where the owner retains subsurface mineral interests. In this case, the owner would still have access to the minerals, but only through use of extraction methods other than surface mining.

These same provisions have been incorporated in H.R. 7318, which is now before the Committee. Both of these provisions are meritorious incentives to encourage private owners to donate interests in land in support of the conservation purposes outlined in the Tax Reform Act of 1976.

The conservation easement is recognized as a useful conservation tool by government agencies and private, nonprofit conservation organizations to be used in lieu of fee acquisition. For example, over half the states have easement laws and the Fish and Wildlife Service has acquired over one million acres of easements in order to protect the habitat for migrating birds.

It is understandable to me that some individuals, who may not wish to sell their land, would be more than willing to give up development or other rights to their property permanently in order to benefit a conservation purpose. Indeed, the entire theory of the easement is predicated on the fact that a landowner can retain ownership and substantial control over his property, yet serve the public benefit by placing restrictions on his property title which permanently protect important conservation resources. Thus, any attempt to require public access to easement areas, especially natural areas, as a condition for receiving a tax deduction would remove a major incentive for the donation of easements. It is perfectly understandable that an individual may choose not to donate an easement for a conservation purpose if the cost to him is sacrificing his own peace and quiet, which may be the effect of requiring public access. Of course, with the consent of the owner, public access can be included in the easement and frequently this will be done to good advantage.

As for the mineral rights aspect of this legislation, amending the tax code to allow deductions for gifts of land where mineral interests are retained by the donor also benefits conservation goals. There are many large tracts of land which are valuable as habitat for fish, wildlife and plants which also have potential mineral values such as oil and gas. It is important that we act now to encourage donation of the surface interests of those areas for conservation purposes while they are still available. Otherwise, as land becomes more scarce, commercial use of these natural areas becomes increasingly attractive. Furthermore, the natural integrity of the donated lands will not suffer major degradation since the proposal prohibits surface mining.

In addition, I would ask the Committee to consider including, either in the bill or in the Committee report, language which would include open space and farmland within the definition of "conservation purpose." Thousands of acres of land in my state of Virginia are protected by easements which cover farmland, mountains, scenic land along rivers and highways, shoreland, watersheds and historic properties. These easements provide a public benefit and should be included within the scope of this legislation.

In conclusion, I believe that it is important that the Congress continue to provide realistic tax incentives for conservation purposes. The provisions of H.R. 7318 make further adjustments to the tax code to achieve this goal. I urge the Committee to act favorably on the bill.

ADVISORY COUNCIL ON HISTORIC PRESERVATION,
Washington, D.C., July 9, 1980.

HON. AL ULLMAN,
Chairman, Committee on Ways and Means, House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: The Advisory Council on Historic Preservation has been interested in the impact of Federal tax policies on the national historic preservation program. In 1976, the Council actively supported amendments to the Internal Revenue Code that provided incentives for the rehabilitation of historic buildings. Also included in that legislation were provisions allowing a charitable contribution deduction for easements donated for conservation purposes, which include the preservation of historic properties. Based on its initial support and continuing interest in these tax provisions, the Council is pleased to offer the following comments on H.R. 7318, "Conservation Easements."

The Council sees no reason to terminate charitable contribution treatment for preservation easements in the tax code. Preservation easements have proven to be effective legal tools to promote the protection of historic properties without costly investment of public funds for outright acquisition. Properties are retained in private ownership, contributing to the tax base and economic life of the communities, while the important historical features are given legally binding protections. Accordingly, the Council supports the continuation of the conservation easement deduction beyond the 1981 "sunset" date, as embodied in H.R. 7318.

In addition to our general support for H.R. 7318, we would like to bring two matters to the Committee's attention as work on this bill progresses. First, regarding the definition of conservation easements, the Committee should note that a Uniform Conservation and Historic Preservation Easement Act is now being considered for adoption by the National Conference of Commissioners on Uniform State Laws (NCCUSL). This represents a product of several years effort of leading experts in the field of preservation, conservation and property law. Although this document is in draft form, there seems to be general agreement upon the definitions of conservation and preservation easements. It is of note that the definition of easement is broken down into two parts, conservation and preservation, obviously recognizing the necessary difference in treatment between easements protecting the natural and the built environment:

1. "Conservation easement" means an interest in favor of a holder imposing limitations or affirmative obligations concerning the use of real property whose purposes include retaining or protecting its natural, scenic or open space values, assuring its availability for agricultural, forest, recreational or open space use, protecting natural resources, or maintaining air or water quality.

2. "Preservation easement" means an interest in favor of a holder imposing limitations of affirmative obligations concerning the use of real property whose

purposes include preserving the historical, architectural, archeological or cultural aspects of real property.

While the Council has taken no action endorsing this particular definition, its staff has actively participated in the development of the Uniform Act. We believe it represents much effort and thought concerning the issues of law and public policy that are involved with conservation easements. We believe the Committee, if it has not already done so, should avail itself of that body of expertise. While it may well be that not all conservation easements that are valid under a State statute modeled on the Uniform Act should be deductible for Federal tax purposes, it would indeed be unfortunate if the Federal tax law were to be amended without due consideration of the related efforts of the NCCUSL, leading to unintentional conflicts or inconsistencies.

A second point we wish to address is the question of ensuring that the public benefit of a deductible conservation easement is realized. Others have raised this issue and propose limitations or certification requirements to resolve what is perceived to be a problem. Again, we wish to call the Committee's attention to the efforts of the NCCUSL. They have addressed this issue through their definition of conservation and preservation easements and by placing certain limitations on who may hold an easement. Without endorsing a specific approach, the Council's participation in the uniform easement effort indicates that reliance on State laws to insure that conservation easements fulfill a public purpose would not be misplaced. An additional burden, both on the taxpayer and the government, of some sort of certification system does not appear worthwhile and could well discourage the use of this preservation tool. To impose such burdens without evidence of abuses over the past five years seems unwarranted. We hope the Committee will explore this matter carefully and draw upon the experience of the NCCUSL.

Finally, the Council would like to urge that the Committee re-examine the issue of the distinction now made in the tax code between easements granted for a term and those granted in perpetuity. The initial legislation passed in 1976 and endorsed by the Council allowed deductions for all conservation easements. The 1977 Tax Reduction and Simplication Act removed this provision for term conveyances and replaced it with a provision requiring the easement to be granted in perpetuity. The sparse legislative history as to why this was changed indicates an unarticulated concern that permitting a deduction for a term would lead to abuse, as one could donate the easement and at the end of thirty years develop the property, having reaped the benefit of a charitable contribution deduction. A distinction needs to be made between preservation and conservation easements for the purpose of discussions regarding terms and perpetual easements. While the easement given in perpetuity may be necessary for the protection of the natural environment, it is not as critical for preserving historic structures in changing urban landscapes. This topic is discussed briefly in the text of Tax Incentives for Historic Preservation, at pages 151–152:

Historic preservationists continue to be troubled by this reinstated requirement of perpetuity for several reasons in addition to those already discussed. Perpetual easements may effectively serve the purpose of natural conservation which is to preserve forever land and other natural resources in a stable, static and ideally undeveloped state, but they do not necessarily best serve the goals of historic preservation. Significant structures should be preserved and protected, particularly when threatened with adverse change, but historic preservationists recognize that they change and deteriorate over time. It may not be possible to assure their preservation forever, at least not without unreasonable cost. In addition, a structure now thought significant may not be so at some future date. Development of the land on which these structures are situated in conjunction with, or in place of, the original structure itself, consequently may be reasonable at some future date. A perpetual easement in such a case, by imposing indefinite requirements to preserve a structure in a static condition, may well not be an effective treatment for a historic property. Instead, term easements arguably can better serve the purposes of historic preservation by guaranteeing the present preservation and maintenance of a property and by providing for a re-evaluation of the property's condition and the desirability of an easement for its protection upon the expiration of the initial easement.

Another consideration is that many owners of significant structures will agree to impose term easements, but not perpetual easements, on their properties. People generally are less willing to impose restrictions on the use and development of property once it has been built on than if the property is still undeveloped. In the latter case a kind of positive inviolability is present and affects people's attitudes.

Finally, the requirement of perpetuity makes little sense with respect to leases and options to purchase. Few, if any, property owners will grant perpetual leases, even with the incentive of a tax break, and even fewer will be willing to encumber their property indefinitely with perpetual options to purchase. Donations of leases and options to purchase make sense in this regard only if they may be granted for finite terms. It is interesting to observe that the original 1972 statutory proposals required no more than 15-year terms for these partial interests in order to make their donation tax deductible.

We hope that the Committee will look closely at the distinct needs of preservation of historic structures as opposed to those of natural area conservation and consider reinstating the term easement provision for such properties.

The Council welcomes this opportunity to comment on H.R. 7318 and would be pleased to offer any additional views to assist the Committee in its deliberations.

Sincerely,

ROBERT R. GARVEY, Jr.,
Executive Director.

STATEMENT OF PAUL H. DELANEY, JR., INTERNATIONAL TAX AND TRADE COUNSEL, MASON, FENWICK & LAWRENCE

The purpose of this memorandum is to provide additional comments regarding conservation easements and related matters with respect to proposed changes in United States income tax law under H.R. 7318, (a revised version of H.R. 4611), a bill to amend the United States Internal Revenue Code to allow a deduction for certain contributions of real property for conservation purposes.

We wish to refer to our previous statement submitted on November 9, 1979 concerning H.R. 4611. That statement reviewed the legislative history of conservation easements and made the following points:

1. The law in this areas is confusing because two separate sections of the Code cover donations of open space easements. One of those sections, 170(f)(3)(B)(iii), will expire on June 14, 1981, while the other, 170(f)(3)(B)(ii), has no sunset date. It was recommended that this overlap be resolved through the legislative process.

2. Donations of partial interests in real property are transactions which require a substantial amount of time to consummate. This is the result of many factors, two of which are (a) finding a responsible donee, and (b) preparing proper legal documentation. It was recommended that because the donation process is lengthy, and because 170(f)(3)(B)(iii) is to expire on June 14, 1981, quick action be taken by Congress so as to enable taxpayers to plan donations properly.

PLANNING DIFFICULTIES AND POSSIBLE CONFUSION INVOLVING INTERNAL REVENUE CODE SECTIONS 170(f)(3)(B)(ii) AND 170(f)(3)(B)(iii)

As noted in our previous submission, under International Revenue Code Section 170(f)(3)(B)(ii) and applicable legislative history and regulations, the gift of an open space easement in gross in perpetuity qualifies as a deductible charitable contribution. Under Section 170(f)(3)(B)(iii), an easement granted in perpetuity exclusively for conservation purposes qualifies as a deductible charitable contribution. It is thus conceivable that a donor wishing to give away the development rights to property in the form of an open space easement could have the gift qualify for a deduction under both of these provisions of the International Revenue Code. In this regard, it is significant that Section 170(f)(3)(B)(ii) has no expiration date, while Section 170(f)(3)(B)(iii) has an expiration date of June 14, 1981.

Under certain theories of statutory construction, the question has arisen whether Section 170(f)(3)(B)(ii) continues to provide an avenue for deductibility of open space easements. This has resulted in confusion and may discourage certain contributions which would be contrary to the intent of Congress.

This confusion and lack of consistency involving Section 170(f)(3)(B)(iii) and Section 170(f)(3)(B)(ii) impacts adversely on donors who, for various reasons, are unable to make orderly gifts prior to the sunset date under Section 170(f)(3)(B)(iii). For example, in certain circumstances, it is important for donors to find responsible donees who will insure that the rights retained by the donor are not infringed. The search for compatible donees may take several years. Similarly, donors with large tracts of land may have difficulties finding organizations and governmental agencies who are willing to accept large gifts with attendant responsibilties. Finally, donors and donees are often required to engage in lengthy negotiations and proceedings involving the rights of the parties and the nature of the legal obligations to be undertaken with respect to a significant variety of state and local law considerations involving real property conveyances and transactions.

Accordingly, prospective donors and donees may need a considerable amount for time in order to accomplish such gifts, and a prospective donor who is faced with the decision to develop the subject property or make a gift which could restrict development may be forced to develop the property owing to the possible uncertainty and confusing under Section 170(f)(3)(B)(ii) and the inability to complete such gifts prior to June 14, 1981. Furthermore, more and more potential donors will be faced with this decision as a consequence of the substantial holding costs of not developing such properties in the present economic context.

BROAD SUPPORT FROM CONSERVATION GROUPS

During the past six months, extensive discussions have taken place involving Treasury Department officials, Members and staff of the House Ways and Means Committee, the Joint Committee staff, representatives of conservation groups, and other interested parties. Many hours have gone into discussing the critical issues, and reaching compromises where differences of opinion have arisen. Such discussions and negotiations led to the introduction of revised legislation in the form of H.R. 7318.

As noted in the recent hearings, conservation groups have given substantial support to H.R. 7318. Certain of these groups seek minor modifications of H.R. 7318 which seem reasonable. All the groups which have testified have unconditionally supported elimination of the June 14, 1981 sunset date.

NEED FOR IMMEDIATE ACTION IN ORDER TO PRESERVE CONSERVATION EASEMENTS AS A VIABLE MEANS OF PROTECTING IMPORTANT PUBLIC POLICY OBJECTIVES

It should be recognized that less than one year is left before the June 14, 1981 expiration date of Section 170(f)(3)(B)(iii). Accordingly, the House Ways and Means Committee should proceed with markup of the subject issues which have been raised before the Subcommittee on Select Revenue Measures in the context of its recent hearings on this matter. The need for timely consideration of these issues is further supported by the confusion which presently exists under the current law, as noted above, in order to enable prospective donors to plan with certainty and thus serve important tax legislative policy objectives regarding conservation and preservation as intended by the Congress.

Notwithstanding the Treasury's position, we wish to note that conservation easements have been in existence for over fifteen years, and apparently no major abuses have come to light during that interval which would be sufficient to suggest that the Congress should abandon the use of the federal income tax laws to encourage donations of partial interests in real property for conservation and preservation purposes.

It is also important to recognize that the Treasury Department has yet to issue regulations on a number of the legislative changes in this area enacted by the Congress in recent years and that the absence of Treasury guidelines on certain of these issues has in turn contributed to the uncertainty in this field and has resulted in additional difficulties for prospective donors who wish to plan for orderly and effective contributions of partial interests in real property for conservation and preservation purposes.

INADVISABILITY OF REQUIRING PUBLIC ACCESS IN ALL CASES

In testimony before this Subcommittee on June 26, 1980, the Treasury Department stated that the public will not directly benefit from donated conservation easements and other interests unless the public has direct access to lands over which easements have been donated. Conservation groups have responded that such a requirement would effectively prevent most donations of conservation easements.

In this context, it is interesting to note that the Department of the Interior has made a determination that the public does derive benefits from grants of partial interests where no public access is allowed. Secretary of the Interior, Cecil D. Andrus, in a letter to G. William Miller dated June 5, 1980, made the following comments with respect to public access: [1]

"Private landowners have been willing to sell or donate conservation easements because the easement does not mandate the intrusion of the general public onto their lands; *yet the public most certainly benefits from the easements because natural resources are being perpetually protected.*" [Emphasis supplied.]

Congressman Joseph L. Fisher stated the following on this matter in his testimony before the Subcommittee on June 26, 1980: [2]

"The entire theory of the easement is predicated on the fact that a landowner can retain ownership and substantial control over his property, yet serve the public benefit by placing restrictions on his property title which permanently protect important conservation resources. *Thus, any attempt to require public access to easement areas, especially natural areas, as a condition for receiving a tax deduction would remove a major incentive for the donation of easements.*" [Emphasis supplied.]

Congressman Andy Jacobs, Jr. and Congressman John D. Dingell related the following in their joint testimony before the Subcommittee: [3]

"Treasury has also suggested several other changes to H.R. 7318, which we rejected as inconsistent with the bill's purposes. The most harmful of their suggestions was that public access be required to easement areas before the donor would be allowed a deduction. Such requirement, in our opinion, would eliminate most easement donations.

Easements are attractive to private land owners because they can retain control over their property. At the same time, the owner makes a contribution to conservation by permanently giving up certain uses of the property. *The benefit to the public lies in the preservation of significant resources such as wildlife habitat.* Besides, if public access to a particular resource is desirable, the area is usually purchased in fee and managed by a government agency." [Emphasis supplied].

A further problem in requiring public access in all instances relates to the shifting of responsibilities to donees. For example, donees would be required, by prudent donors, to hold the donors harmless against any personal injury claims brought against the donor by members of the general public injured on the property. This would require the donee to carry liability insurance, resulting in additional costs to the donee. According to several conservation groups, this shifting of responsibility would greatly increase the cost of preserving environmentally important lands via conservation easements.

CONCLUSION

In order to eliminate confusion and uncertainty which exists under present law with respect to Section 170(f)(3)(B)(ii) and Section 170(f)(3)(B)(iii), it is urged that the Congress eliminate the sunset provision for Section 170(f)(3)(B)(iii) (and probably for Section 170(f)(3)(B)(iv) as well) to obtain needed consistency in this area.

Based on the points, authorities and considerations set forth above, it is urged that the House Ways and Means Committee Subcommittee on Select Revenue Measures proceed as soon as possible with its markup of the subject legislation, so as to continue and encourage the important public policy objectives of conservation and preservation.

We wish to thank the Members and staff of the House Ways and Means Committee Subcommittee on Select Revenue Measures for providing us an opportunity to express our views on these issues.

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[1] Letter to G. William Miller, Secretary of Treasury from Cecil D. Andrus, Secretary of Interior, June 5, 1980, p. 2.

[2] Testimony of Congressman Joseph L. Fisher before the Subcommittee on Select Revenue Measures, of the House Ways and Means Committee, June 26, 1980, p. 1 and 2.

[3] Statement of John D. Dingell and Andy Jacobs, Jr. before the Subcommittee on Select Revenue Measures of the House Ways and Means Committee, June 26, 1980, p. 1.

PIEDMONT ENVIRONMENTAL COUNCIL,
Warrenton, Va., June 25, 1980.

Hon. DAN ROSTENKOWSKI,
Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, Longworth House Office Building, Washington, D.C.

DEAR MR. ROSTENKOWSKI: The Piedmont Environmental Council regrets that it will not be possible for us to appear at the hearings on H.R. 7318 scheduled for June 26, 1980. As you are no doubt aware, we have asked Mr. Tyson Van Auken, Executive Director of the Virginia Outdoors Foundation, to associate us with the statement he will be presenting on behalf of the Commonwealth of Virginia.

We are writing here to express our further views as to H.R. 7318. While we support the intent of the legislation, we should note at the outset that we could support the bill only with modifications which would broaden the language with regard to conservation purposes.

The Piedmont Environmental Council is a Virginia-based land planning and conservation organization of the type described in Section 501(c)(3) and which meets the requirements of Sections 509(a)(1) and 170(b)(1)(A)(vi) of the Internal Revenue Code. Since its founding in 1972, the Council has played an active role in educating its members and the public with regard to the value of conservation easements and in promoting the donation of easements to the agency charged under Virginia law with the preservation of open space, the Virginia Outdoors Foundation.

As is pointed out in the statement submitted by Mr. Van Auken, the conservation purposes identified in The Virginia Open-Space Land Act are very broadly defined, and we believe this broad definition has contributed in large measure to the success of the State's easement program.

As indicated above, we would urge the Subcommittee to give the widest possible scope to the definition of "conservation purposes." With the continuing conversion of undeveloped land to other uses, we believe it is increasingly in the national interest for federal tax policy to encourage the preservation of open space. Any narrowing of the purposes currently allowed could undercut the effectiveness of the conservation easement, which we have found to be our single most useful tool in preserving open space. We believe some modifications are essential if the Bill is to serve the public interest in maintaining the effectiveness of our easement program.

With regard to Paragraph 4, we are disturbed at the implications of the consistency test, in particular as it may relate to both farming and forestry. It should be clearly stated that such uses can be consistent with the purpose of the gift. We are troubled that absent the undivided interest rule and the liberal regulations which have interpreted it, the requirement that conservation easements must be either scenic or protective of natural systems could lead to curtailment of existing programs. For example, we would point out that the donation of such property rights as building height allowances and conservation easements on land not visible to traffic on a public highway have qualified under existing law but might not under the proposed test. We believe the public interest amply supports the deductability of such gifts.

In addition to the above, we would like to commend to the Subcommittee the following specifics which we believe must be included in any definition of conservation purposes:

The preservation of open space, including agricultural and forestal lands and scenic and cultural landscapes; the preservation of historic structures and land areas, including the setting of historic structures; the preservation of natural systems, with special reference to the habitats of plant and animal species and to environmentally fragile areas; education and recreation.

With the modifictions indicated herein, PEC would be able to support H.R. 7318. We appreciate this opportunity to make our views known to you and to the Subcommittee.

Sincerely,

CHAPLIN B. BARNES,
President.

SOCIETY FOR THE PROTECTION OF NEW HAMPSHIRE FORESTS,
Concord, N.H., July 1, 1980.

Hon. DANIEL ROSTENKOWSKI,
Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, Longworth House Office Building, Washington, D.C.

DEAR CONGRESSMAN ROSTENKOWSKI: This is a follow-up to the testimony given on our behalf by Benjamin R. Emory of the Maine Coast Heritage Trust on June 26, 1980.

We wholeheartedly support the two revisions to HR 7318 proposed by Mr. Emory and others, specifically: (1) to assure the eligibility of certain support organizations as described under Section 509(a)(3) of the Code, and (2) clarifying the "Conservation Purposes Test" to qualify for tax deductions to include forest, farm and open space land.

Our concerns in the latter regard are satisfied by the proposal of the Maryland groups, namely, including in the definition of Conservation Purposes the statement:

"The preservation of open space, farmland, or forestland where such preservation is in furtherance of a local, state or national policy."

Our conservation easement program in New Hampshire during the past six years has protected over 7,000 acres of open space, including forest and farmland, unique natural areas and watershed resources. The thrust of our program, however, has been conservation of productive resource areas, particularly forest land.

The Forest Society, since its inception in 1901, has promoted multiple use forest management which benefits the timber, wildlife and recreational resources of the property. Our easements prohibit development while encouraging wise use of natural resources.

In response to Treasury's concerns regarding appraisals of restricted land, the "before and after" appraisal of forest land uses the resource value (capitalized projected income from forest management) as the "after" value. We helped develop this method, and it has proven to be an effective measure of the property's residual or restricted value.

The tightening federal budget will force greater reliance on the private sector to retain our resource lands in productive use for food, fiber and fuel. It is our view that private sector incentives and initiatives must be encouraged, not curtailed.

Our Society has a respected and successful easement program; our easement monitoring procedures are tight and occur on a yearly basis. Thousands of New Hampshire acres are protected in perpetuity while remaining in private ownership and under active management.

It is our Society's strong conviction that the conservation easement has proven to be one of the most cost-effective protection techniques available. It is clearly in the national interest and for the public benefit to encourage their continued use. We urge your committee to amend HR 7318 to clarify, broaden and encourage the use of the conservation easement in the protection and conservation of our nation's natural resources.

Cordially,

PAUL O. BOFINGER,
President/Forester.

H.R. 7392

A BILL Relating to the treatment of certain expenses includible in the income of the recipient

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) subsection (e) of section 274 (relating to specific exceptions to application of disallowance of certain entertainment, et cetera, expenses) is amended by adding at the end thereof the following new paragraph:

> "(10) EXPENSES INCLUDIBLE IN INCOME OF PERSONS WHO ARE NOT EMPLOYEES.—Expenses paid or incurred by the taxpayer for goods, services, and facilities to the extent that the expenses are includible in the gross income of a recipient of the entertainment, amusement, or recreation who is not an employee of the taxpayer as compensation for services rendered or as a prize or award under section 74. The preceding sentence shall not apply to any amount paid or incurred by the taxpayer if such amount is required to be included (or would be so required except that the amount is less than $600) in any information return filed by such taxpayer under part III of subchapter A of chapter 61 and is not so included."

(b) The amendments made by this Act shall apply to any expenses paid or incurred after December 31, 1980.

SUMMARY

Present law

Prior to the enactement of the Revenue Act of 1978, expenses incurred with respect to entertainment facilities[1] were deductible if they were ordinary and necessary, the facility was used primarily for the furtherance of the taxpayer's business (i.e., more than 50 percent of the time that it was used), and the expense in question was related directly to the active conduct of the taxpayer's business. For this purpose, entertainment facility expenses included dues or fees paid to any social, athletic, or sporting club or organization. Dues or fees paid to professional associations, civic organizations, or to clubs operated solely to provide meals under circumstances normally considered to be conducive to business discussions generally were not considered to be entertainment facility expenses.

In determining whether an entertainment facility was used primarily for business purposes, all the taxpayer's ordinary and necessary business use of the facility was taken into account. Once it was determined that the facility was used primarily for business, the portion of the expenses which were related directly to the active conduct of the taxpayer's business could be deducted.

The Revenue Act of 1978 provided generally that no deduction was allowable for any entertainment facility expense. However, the Act retained a number of exceptions to the general rule that existed under prior law. One of these relates to expenses treated as employee compensation (sec. 274(e)(3)). Under this exception, expenses for goods, services, and facilities are not subject to the disallowance rules to the extent that the expenses are treated by the taxpayer, with respect to the recipient of the entertainment, as compensation to an employee on the taxpayer's return and as wages to the employee for purposes of income tax withholding. Thus, in the case of facility expenses which satisfy this exception, the Act retained the rules of prior law which formerly had applied to expenses treated as employee compensation.

The Technical Corrections Act of 1979 provided that the provision disallowing expenses for entertainment facilities did not apply to expenses paid or incurred in 1979 or 1980 where the entertainment facilities are provided to a nonemployee of the payor, the amount of the expense is includible in the gross income of the recipient of the entertainment facilities as compensation for services or as a prize or award, and the payor complies with any required reporting of information return (i.e., an information return (Form 1099) is furnished to the Internal Revenue Service (but not the recipient) for amounts in excess of $600).

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[1] An entertainment facility generally is any item of personal or real property owned, rented, or used by a taxpayer during the taxable year for, or in connection with, an activity normally considered to be of an entertainment nature.

Issue

The issue is whether the limitations of the Revenue Act of 1978 on entertainment facilities ought to apply to expenses of the taxpayer for facilities provided to nonemployees where the amount of the expense is includible in the gross income of the recipient as compensation or as a prize or award and the taxpayer provides the Internal Revenue Service with any required information return indicating the amount to be included in the gross income of the recipient, regardless of the amount involved.

Explanation of the bill

The bill would provide that disallowance of expenses for entertainment, amusement, or recreation expenses (Code sec. 274(a)) does not apply to expenses which are includible in the gross income of the recipient of the entertainment, amusement, or recreation as compensation for services or as a prize or award under Code section 74. This exception would not apply to a payor unless he furnished the Internal Revenue Service with any required information return (Form 1099) indicating the amount to be included in the gross income of the payee, regardless of the amount involved.

Effective date

The bill would be effective to expenses paid or incurred after December 31, 1980.

Revenue effect

It is estimated that this bill will have no direct effect on budget receipts.

JULY 1, 1980.

Hon. DANIEL ROSTENKOWSKI,
Chairman, Subcommittee on Select Revenue Measures,
Longworth House Office Building Washington, D.C.

DEAR MR. CHAIRMAN: Pursuant to your press release of June 13, 1980 announcing a public hearing on H.R. 7392, the undersigned companies wish to express their endorsement of this bill and submit the following comments for the consideration of the Subcommittee and inclusion in the printed record of the hearing.

On April 1, 1980, the Technical Corrections Act of 1979 (H.R. 2797) was enacted, providing in section 103(a)(10)(C) thereof a temporary rule, applicable to 1979 and 1980, for the "Use of Facilities in Case of Indepenedent Contractors, Etc." In presenting H.R. 2797 to the House, you noted that the provision concerning use of facilities by independent contractors was included to deal with an "unintended consequence" of the Revenue Act of 1978. However, a temporary solution was enacted due to objection by the Treasury Department that the proposed solution might be "overly broad." See Congressional Record H. 1984–85 (daily ed. March 19, 1980).

H.R. 7392 will provide, with the concurrence of the Treasury, a permanent solution to a problem of unintended disallowance of certain expenses, which would otherwise arise again after 1980. The problem results from the fact that section 274(a)(1)(B), added by the Revenue Act of 1978, may be interpreted—incorrectly in our view—so as to conflict with section 274(h)(6)(D)(ii) and disallow the deduction, by an incentive program sponsor, of expenses for incentive travel awards which are includible in the gross income of the award recipients. For example, a dealer who exceeds a sponsoring manufacturer's sales objective may earn a trip award which will then be includible in the dealer's gross income under section 74 of the Internal Revenue Code. H.R. 7392 would make it clear that the expenses of such incentive awards are deductible by the manufacturer, without changing any rules of section 274 which deny deductibility by the award recipient. This technical change will conform the language of section 274(a)(1) to Congressional intent as expressed in the Report of the

Senate Finance Committee on the Revenue Act of 1978. In order to meet the previous Treasury Department concern, relief is conditioned upon compliance with certain information reporting rules.

Section 274(a)(1) was amended by section 361(a) of the Revenue Act of 1978 in order to limit the deduction allowed with respect to entertainment facilities. As explained in the Report of the Senate Finance Committee,

"Generally, the term 'facility' includes any item of real or personal property which is owned, rented, or used by a taxpayer in conjunction or in connection with an entertainment activity. Thus, expenses incurred with regard to entertainment facilities which are disallowed, include yachts, hunting lodges, fishing camps, swimming pools, tennis courts, and bowling alleys. Facilities also may include airplanes, automobiles, hotel suites, apartments and houses (such as cilities, the Revenue Act of 1978 also specified that the restrictions on the deduction is not affected unless the property is used in connection with entertainment." S. Rep. No. 95–1263 at 174–75.

The Senate Finance Committee Report expressly stated that the facilities amendment was not intended to change the rules applicable to overnight business travel or conventions. As stated in the Committee Report,

"[T]he bill generally would not apply to expenses incurred by an individual away from home at a bona fide business, trade, or professional organization meeting or convention. These expenses, however, would continue to be subject to the generally applicable rules relating to the deductibility of business travel, convention, and entertainment activity." Id. at 175.

In addition to the above described amendment concerning entertainmet facilities, the Reveue Act of 1978 also specified that the restrictions on the deductibility of foreign convention expenses should not cause a double disallowance of such expenses under circumstances where the cost of an incentive travel award was paid by one person as a business expense and includible in the income of another person. As explained in the Report of the Senate Finance Committee,

"For example, where a manufacturer purchases tickets for the attendance by one or more of the employees of its dealers at a foreign convention as an incentive award and transfers the tickets to its dealers who in turn award them to certain employees, the manufacturer will not be subject to these limitations (on deductibility) if the tickets are includible in income of the dealer and the manufacturer complied with any required information reporting. Further, the limitations will not apply to the dealer for any amount if the employee is required to include that amount in his income and the dealer complies with the applicable information reporting requirements. Of course, the rules described above limiting deductions for foreign conventions continue to apply to the individual involved to determine the extent to which he is entitled to deduct the convention expenses." S. Rep. No. 95–745 at 18–19.

Under section 274(a)(1) as amended by the Revenue Act of 1978, it appears that expenses for an incentive travel award (foreign or domestic) might be considered nondeductible by the payor, even though the value of the award is includible in the income of the recipient and is properly reported on any required information return. An amendment with permanent effect is therefore necessary to resolve for future years any inconsistency between the amendment to section 274(a)(1) and the amendment to section 274(h), both of which were included in the Revenue Act of 1978.

The uncertainty concerning the application of the broad language of section 274(a)(1)(B) has created a deterrent to incentive programs involving travel awards. This uncertainty has an adverse effect on the undersigned companies which are sigificantly engaged in the business of conducting, for sponsoring companies, incentive programs which offer travel and merchandise awards to persons who attain high levels of achievement.

H.R. 7392 will preclude this obviously unintended interpretation of the Revenue Act of 1978. The Bill basically tracks the provisions of section 103(a)(10)(C) of the Technical Corrections Act of 1979, except that to avoid disallowance of deductions in future years, all amounts paid or incurred which are required to be reported in any information return must be so reported without regard to the general provisions for information returns which exclude amounts less than $600. We understand that, as a result of eliminating the $600 threshold amount, the bill has the approval of the Treasury. As noted above, it was Treasury objections that caused the previous remedial provision to be only temporary. See Congressional Record H. 1985 (daily ed. March 19, 1980).

The restrictions on the deductibility of entertainment activities and facilities would of course remain applicable to the recipient of a trip award as well as to any person who pays for the expenses of a travel award under circumstances where the recipient is not required to include such expenses in his gross income.

Respectfully submitted.

WILLIAM M. SHUMATE,
Vice President, Travel,
Business Incentives, Inc.

JAMES B. GOODMAN,
Director, Administration,
E. F. McDonald Travel Co.

J. E. TRABERT,
President,
International Travel Associates, Inc.

HENRY S. STOLAR,
Vice President and Associate
General Counsel, Martiz, Inc.

JOHN HEIM,
Vice President,
Carlson Marketing Group, Inc.

WILLIAM G. WELLER,
President,
S&H Motivation and Travel, Inc.

CHARLES A. QUINLAN,
Vice President-Secretary,
Top Value Enterprises.

H.R. 7487

A BILL To amend the Internal Revenue Code of 1954 to impose a manufacturers excise tax on the sale of light gauge steel drums

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) chapter 32 of the Internal Revenue Code of 1954 (relating to manufacturers excise taxes) is amended by inserting after subchapter B the following new subchapter:

"Subchapter C—Light Gauge Steel Drums

"Sec. 4131. Imposition of tax.

"SEC. 4131. IMPOSITION OF TAX.

"(a) Tax Imposed.—There is hereby imposed on the sale by the manufacturer, producer, or importer of each light gauge steel drum a tax equal to 20 percent of the price for which so sold.

"(b) Light Gauge Steel Drum.—For purposes of this subchapter, the term 'light gauge steel drum' means any drum—

"(1) the body of which is of steel sheet lighter than 18 gauge, and

"(2) which has a liquid capacity of at least 35, but not more than 65, United States gallons."

(b)(1) Subsection (a) of section 4218 of such Code (relating to use by manufacturer or importer considered as sale) is amended by inserting "or any light gauge steel drum taxable under section 4131" after "under section 4121".

(2) Subsection (a) of section 4221 of such Code (relating to certain tax-free sales) is amended by striking out "section 4121" and inserting in lieu thereof "sections 4121 and 4131".

(3) Section 4293 of such Code (relating to exemption for United States and possessions) is amended by striking out "and 4121" and inserting in lieu thereof ", 4121, and 4131".

(4) Paragraphs (2) and (3) of section 6416(b) of such Code (relating to special cases in which tax payments considered overpayments) are amended by inserting "or any light gauge steel drum taxable under section 4131" after "section 4121".

(c) The table of subchapters for chapter 32 of such Code is amended by inserting after the item relating to subchapter B the following new item:

"Subchapter C. Light gauge steel drums."

(d) The amendments made by this Act shall apply with respect to sales after the 180th day after the date of the enactment of this Act.

Summary

Present law

Under present law, there is no excise tax imposed on lighter gauge or other steel drums.

Issue

The issues raised by this bill include the following:

(1) Whether an excise tax should be imposed upon lighter gauge steel drums in order to encourage the use of heavier gauge steel drums which can be reconditioned and re-used more times.

(2) Whether increased use of heavier gauge steel drums will reduce the volume of drums disposed of without reconditioning and thereby minimize the risk of contamination of the environment from residues in the drums disposed of.

(3) Whether any increased use of drums which can be reconditioned more times will result in significant energy savings.

Explanation of the bill

The bill would impose an excise tax on the sale by the manufacturer, producer, or importer of lighter gauge steel drums. The tax would be 20 percent of the sale price. Under the provisions of the bill, a lighter gauge steel drum means any drum the body of which is of steel sheet lighter than 18 gauge and which has a liquid capacity of at least 35, but no more than 65, United States gallons. In general, the tax would apply to drums which cannot be reconditioned or can be reconditioned only two or three times.

Effective date

The bill would apply with respect to sales after the 180th day after the date of enactment.

Revenue effect

It is estimated that this bill will increase budget receipts by less than $10 million in fiscal year 1981, by less than $5 million annually in 1982 and 1983, and by negligible amounts in later years.

CHEMICAL MANUFACTURERS ASSOCIATION,
Washington, D.C., July 9, 1980.

Hon. DANIEL ROSTENKOWSKI,
Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, Longworth House Office Building, Washington D.C.

DEAR MR. CHAIRMAN: The Chemical Manufacturers Association (CMA) submits the following statement for the record of the June 26, 1980 hearing on H.R. 7487, a bill to amend the Internal Revenue Code of 1954 to impose a manufacturers excise tax on the sale of light gauge steel drums.

CMA is a nonprofit trade association having 192 United States company members representing more than 90% of the production capacity of basic industrial chemicals within this country. Our members operate nearly 1500 plants and numerous terminal facilities located in nearly every state. They are substantial users of 55 gallon steel drums for the transportation of raw materials and finished products and are the largest industry user of the 20/18 gauge steel drum which would be subject to the tax proposed in H.R. 7487.

H.R. 7487 was introduced in early June as was the subject of a hearing on June 26. We understand it will be subject to mark-up in the near future. We are concerned that in that short period of time many who will be substantially adversely affected by this legislation, if enacted, will not have had an opportunity to consider the consequences and make their comments known to the subcommittee. The members of the Congress themselves will not be in a position to properly evaluate and act on the proposed legislation.

While we support sound programs directed towards conserving energy and other natural resources and measures to expand commerce of the United States, we are seriously concerned that H.R. 7487 does not in fact approach those goals.

The major reason for using new rather than used drums for transporting chemicals is the need to maintain high quality and to avoid any contamination from residues of previous materials in the chime and rolling hoop areas of the drums. Also, tight-head reconditioned drums cannot be satisfactorily coated to prevent corrosion of iron pickup, contamination of chemicals from residues. Iron pickup and corrosion could substantially affect product quality and in some instances could be reactive with the new contents.

H.R. 7487 is inflationary. It is estimated that the increase in drum cost because of the excise tax will exceed $30 million a year for the chemical industry. These additional costs would result whether or not industry paid the additional cost for the light gauge drums as imposed by the tax or move to the use of heavier gauge drums. It would also result in higher freight costs for the transportation of empty containers, raw materials and finished products because of the difference in the tare weight of the two drums.

We seriously question the claim that the use of reconditioned heavy gauge drums would conserve energy to any great extent.

Also there is some concern that the bill would reduce incentive for steel drum improvement programs. Most of these programs to date have been directed to more efficient use of steel as well as improving the integrity of the drum (such as a tripleseam chime drum) to assure safety in transportation.

The bill would result in a significant worsening of the U.S. trade balance. Shipments of chemicals and allied products were valued at nearly $147 billion dollars in 1979. Chemical exports totalled $17.3 billion in 1979 while chemical imports totalled $7.5 billion dollars for a net trade balance of $9.8 billion dollars. To the extent that the excise tax would place U.S. chemical shippers at a serious disadvantage in competing for the export business, the favorable trade balance could be seriously and adversely affected. Many companies, large and small, are involved in exporting chemicals. They have a substantial interest in the proposed legislation which could substantially affect their exports.

The prerogative for selecting the type of drum for a specific chemical should remain with the manufacturer of the chemical. He should not be forced by arbitrary legislation or regulation to adopt containers that put him at a competitive disadvantage with no offsetting safety or other improvement.

We appreciate the opportunity to submit these comments for the record of hearings on H.R. 7487.

Sincerely,

ROBERT A. ROLAND,
President.

CONTAINER PRODUCTS,
U.S. STEEL SUPPLY,
DIVISION OF UNITED STATES STEEL CORP.
Chicago, Ill., June 20, 1980.

Hon. DAN ROSTENKOWSKI,
U.S. House of Representatives,
Washington, D.C.

DEAR MR. ROSTENKOWSKI: It has come to our attention that the H.R. 7487 House Bill "To Amend the Internal Revenue Code of 1954 to Impose a Manufacturers Excise Tax on the Sale of Light Guage Steel Drums" is scheduled for hearing on June 26. We, as a manufacturer of New Steel Shipping Containers are opposed to the Bill that proposes a 20 percent Excise Tax on all steel drums of 37 to 65 gallons that are made of less than 18 gauge steel. The most popular drum in use in the United States, and authorized by the D.O.T. for shipping hazardous products is a 55 gallon, 20 gauge body with 18 gauge ends. This drum is authorized for many hazardous products and is reconditionable and reusable.

We believe that putting a tax on drums lighter than 18 gauge would impose an unnecessary added cost on shippers that would utimately be paid by the consumer.

From an Energy and Raw Material Conservation standpoint, we firmly believe that going to the heavier 18 gauge drum would be counter productive, as the lighter gauge 20/18 has proven itself in the market place.

We recommend this Bill be voted "No."

Very truly yours,

C. I. GIBSON,
Manager, Manufacturing.

GULF OIL CORP.,
Washington, D.C., July 9, 1980.

Hon. DAN ROSTENKOWSKI,
Chairman, Select Revenue Measures Subcommittee, of the House Ways and Means Committee, Longworth House Office Building, Washington, D.C.

DEAR CONGRESSMAN ROSTENKOWSKI: On June 26, the Subcommittee on Select Revenue Measures of the House Ways and Means Committee held a hearing on H.R. 7487, which would impose a 20 percent excise tax on light gauge steel drums. Gulf Oil Corporation opposes this legislation as being not in the public interest. We know that lighter than 18 gauge steel drums are safe, efficient, environmentally sound, can be recycled, lighter and cost less to the consuming public.

Gulf takes this opportunity to submit for the record our position on this legislation. We trust that you will give our concerns your serious consideration.

Sincerely,

L. H. BONIN, JR.

Attachment.

Gulf Oil Corp. Statement for the Record on H.R. 7487

H.R. 7487 was introduced June 4, 1980 by Congressman Guarini and co-sponsored by Congressmen Rostenkowski, Florio, and Madigan. This bill would levy a 20 percent excise tax on light guage steel drums. The intent of H.R. 7487 is to make it economically favorable for the drum industry to use heavy guage (18 guage or heavier) drums as opposed to light guage. This would benefit the steel drum reconditioning industry while working to the deteriment of the American public. Gulf opposes H.R. 7487 as it is not in the public interest.

A light guage steel drum is defined as a drum, the body of which is made from steel sheets, lighter than 18 guage and which has a liquid capacity between 35 to 65 U.S. gallons. The tax would be imposed on a manufacturer, producer, or importer, even if the light guage drum was used by such a person and not sold. The tax would be imposed on all sales including those to the U.S. Government. A 20 percent excise tax on a sale of an 18 light guage drum would boost the overall cost of the drum to $21.60, which would be more expensive than heavier (18) guage drums.

The trend for several years in the lube oil industry has been toward lighter guage drums. Light guage drums cost less, weigh less, are easier to handle, and are cheaper to transport. Historically, there has always been a trade-off between the advantages of a light guage drum and its durability against leaks. The heavier the guage, the less risks of damage causing spills. However, with new advances in seams technology, it has been possible to use lighter guage steel to minimize cost, and to still meet durability standards. It would not be practical to enact legislation that, in effect, would attempt to reverse the economic efficiencies that are being generated by major technological advances in drum design.

While 18 gauge drums are appropriate for many uses, there is nothing which makes 18 gauge appropriate for all users. Considering the wide variety of products transported in steel drums and the various modes of transportation used over long distances, it is important that the industry be free to sell products in the range of containers required to meet the varying needs of different kinds of customers. It would be an economic waste to require customers to purchase more packaging (i.e., heavy gauge drums) than is required for safe transport.

It would also be a serious waste of resources, if shippers were forced by the proposed excise tax to abandon the use of some steel drums, which can be recycled, in favor of plastic containers which have little potential for recycling. To avoid this situation, industry should be allowed to safely meet customer requirements at the lowest possible cost.

From a safety and environmental perspective, lighter gauge drums have proven to be safe, efficient, and environmentally sound. They are required to meet stringent standards established by the Department of Transportation.

Since light gauge drums weigh less than heavy gauge drums, the fuel cost of shipping them and the products which they contain is less for a heavier gauge drum. H.R. 7487 would encourage the use of heavy gauge drums and be in direct conflict with the goals of the President's energy conservation program.

H.R. 7487 would increase packaging, handling, and transportation costs for the producer and shipper of products. The retailer would necessarily have no choice but to pass on these cost increases to the consumer. If H.R. 7487 became law, the consumer would pay more for products and services without receiving any additional benefits whatsoever.

H.R. 7487 is energy and resource inefficient. It is in direct conflict with the goals of energy conservation, and it is inflationary. H.R. 7487 is not in the public interest and should not be pursued. If steel drum reconditioners merit government assistance, Gulf suggests that other, more direct measures be employed that do not penalize users or the general public.

Myers Drum Co.,
Oakland, Calif., June 24, 1980.

Hon. Fortney H. Stark,
House of Representatives,
Longworth House Office Building, Washington, D.C.

Dear Congressman Stark: It has come to my attention that a bill, H.R. 7487, seeks to amend the Internal Revenue Code to impose a manufacturing excise tax on the sale of light gauge steel drums. Proponents of the bill include a number, but not all of the members of the National Barrel and Drum Association (NABADA), the association representing steel drum reconditioners in the United States.

Specifically, the bill would impose a tax equal to 20 percent of the selling price of a lighter than 18 gauge steel drum with a capacity between 35 and 65 gallons. Congressman Guarini's comments to the House of Representatives reported in the Congressional Record of June 4, 1980, indicate the benefits of such a bill, were it to be passed, include the following:

1. Salvation of the drum reconditioning industry. The implication is that this industry will not survive without the passage of this bill.
2. Environmental impact including alternate methods of disposal of used drums not being available and the undesirability of steel drums as steel scrap with reference to the increased midnight dumping of chemicals.
3. Reduced energy consumption through reuse of heavier gauge steel drums.
4. Conservation of natural resources through increased usage of heavier gauge steel drums.

The foregoing are high and lofty goals and well deserving of your support if the information and facts presented to you are factual and correct. Such is not the case however, unfortunately, the bill as proposed by NABADA is not altruistic in nature and concerned with energy conservation and the preservation of natural resources but, rather was developed as a vehicle to serve the financial interests of a small, special interest group within the reconditioning industry.

As a former active member of the NABADA group, as a former officer and now an active member of the Steel Shipping Container Institute (SSCI), the association representing new steel container manufacturers; as General Manager of the largest reconditioner of steel drums in the United States, a company also well established in the manufacturing of new steel drums, I feel that I am in a position to objectively assess the impact of this bill upon both industries. I have over 22 years of training and experience in both reconditioning and manufacturing; so much for my qualifications. I hope you will agree that my experience and background, coupled with my managerial responsibilities, qualify me as an objective industry spokesman. I would like to comment briefly on the specific issues raised and referred to in H.R. 7487.

Collection and disposal system

The drum reconditioning industry has existed since the turn of this century when drums began to be manufactured from steel. Initially, the first steel drums were built from 10, 12 and 14 gauge steel. The reconditioning industry existed before the invention of the steel drum, primarily as cooperages or recoopers of wooden drums. Our own company has been in existence over 65 years and many of the members of NABADA can boast of similar longevity. The alleged shortage of steel drums does not now threaten, nor has it ever threatened, the continuation of the reconditioning industry. Yes, some companies in this industry have failed and, obviously others will yet fail, as they do in all businesses; but our industry continues to grow with new companies entering the field. Those companies that will fail, will not fail as the result of any drum shortages. The main cause of failure this day and age is the difficulty of complying with the ever increasing demands made upon this industry by governmental bureaucracy and regulatory agencies.

Have no fear, this industry is tough, it will survive by becoming more competitive and adapting to the conditions in the marketplace. I, for one, am proud of our industry and role we play in servicing the nation's industrial container requirements. Without the demise of the reconditioning industry, there is no need to concern ourselves with alternate methods of disposal of empty used drums in landfill or scrap yards. The so-called midnight dumping of chemicals does not relate as much to drum availability, as it does to dishonest, unscrupulous individuals who will always circumvent the law for personal gain.

Heavier gauge steel drum production

H.R. 7487 contends that the future existence of the reconditioning business is dependent upon the availability of heavier gauge steel drums which can be reconditioned. This is completely erroneous. We have, over the years, conducted numerous tests relative to the reconditionability of 18 gauge steel drums vs. lighter gauge drums. This particular argument has continued unabated by a small group with NABADA for almost 15 years. Within NABADA, there are many members who do not agree with the lighter gauge drum argument.

I resigned from active membership in NABADA over this very issue several years ago and have opposed NABADA's position on this subject on many occasions. Other NABADA members have expressed a desire not to pursue government intervention or seek governmental support in this area.

If the NABADA point is a valid one, and the 18 gauge drum is better and will survive the reconditioning process a greater number of times, then the key here is "heavier is better". Why not propose a return to the heavier gauges of yesteryear, when drums were manufactured from 10, 12 and 14 gauge steel. Why these drums would last forever and we would not need a new drum manufacturing industry at all.

The truth of the matter is that the gauge of the drum does not really determine the reconditionability of the steel drum. What really determines the reuse factor of the steel drum is how the drum was handled while in transit. The real culprits, those that affect the life of the drum, include mishandling of drums by carriers, by forklift operators, by dropping of filled or partially filled containers, etc.—these factors seriously affect the life of the drum. Without these external influences, the all 20 gauge drum can be reconditioned as many times as the 18 gauge drum. It is not an uncommon occurrence to find a lighter than 18 gauge drum still in use even though the drum may be 10 to 15 years old.

We have, over a period of years, conducted a number of tests on the reuse factor of drums. I agree with the statement that an 18 gauge drum can be reconditioned nine or more times. I disagree very strongly with the statement that light gauge drums can only be reconditioned two or three times. We have documentation that light gauge steel drums can be reconditioned as many times as can the 18 gauge drum.

In a carefully documented test conducted several years ago, we ran a series of tests on all 20 gauge drum, using 18 gauge steel drums as a control. These tests were undertaken in specific response to the question of 18 gauge vs. lighter gauge drum reuse. A number of all 20 gauge drums were shipped filled from East Coast plants to our plant in Los Angeles. The average weight of these drums filled exceeded 500 lbs. The drums were received in Los Angeles, emptied, reconditioned, refilled, loaded on a carrier and shipped to our facility in Northern California where they were again emptied, reconditioned, filled and reloaded for shipment to Los Angeles. This procedure was repeated over and over until the drums had been shipped 7 times between our two plants. We then shipped the drums back to the East Coast, also filled, for further evaluation. I can report that there was no appreciable difference in the performance of the light gauge steel drum when compared with the control drums. The test results are available for your inspection should you so desire to see a copy.

NABADA would have you believe that the new drum industry has undertaken the manufacture of light gauge drums in an effort to eliminate the reconditioning industry as a competitor in the container marketplace. There has been a trend, over the last 80 years, toward lighter gauge drums. This trend is not unlike the trend in the automotive industry toward lighter weight cars. Both come about as a result of improvement in the product. With the development of lighter weight plastic and fibre drums, the new steel drum industry has had to respond to the customer request for a better product at a lower price or lose posture in the market. The trend toward lighter gauge steel drums is a self-preservation move. If the new steel drum industry is unable to respond, the conclusions are inevitable. The new steel drum industry, on the other hand, has not sought to control the competitive plastic or fibre drums with an excise tax bill. Instead, the new steel drum industry has responded with research and development to develop competitive products to meet the competitive challenges and not with legislation intended to control the competition.

Let me assure you, when and if it becomes necessary, the reconditioning industry has the ability to recondition paper bags, and more than that, we will do it profitability. Most of us in the reconditioning industry want less governmental involvement in our business and not more, as this bill would seek to do. President Carter has suggested that he intends to move in that direction. Recent decontrol of the airline industry and a recent announcement concerning decontrol of the trucking industry are solid evidence that we are beginning to move ahead. Let's not remove some of the binders and then add others just as we are beginning to make some progress in the area of decontrol.

Energy conservation

The reference to energy conservation in the bill states that it requires 10 times more energy to manufacture a new steel drum than to recondition a used drum.

This information was taken from a 1974 study commissioned by NABADA to determine the energy requirements of reconditioning steel drums vs. discarding, recycling, scrapping or melting. The authors of this study, a husband and wife team, were not at that time recognized as experts in the field of energy conservation or usage. In the report, it identifies one author as an economist and the other is described as an Associate Professor of Aeronautical and Astronautical Engineering at the University of Illinois. The study has been the target of much criticism since its publication in 1974. The conclusions and the validity of their findings have been, to say the least, very questionable.

In response to the comments made by Mr. Guarini, when introducing the bill in Congress, the comment was made that purchasing of new steel drums was prohibited immediately following World War II unless the user had reconditioned his supply of drums as many times as was possible. This, of course, had nothing to do with the shortage of used drums, or even light gauge steel drums.

I am sure you realize that this particular action was initiated due to the serious shortage of steel that existed in the United States at that time.

There are thousands and thousands of Americans gainfully employed in the new steel drum industry throughout the United States. The limiting of production that would result with the passage of H.R. 7487, could put hundreds, possibly thousands, of workers out of jobs when you consider the domino effect. The new drum industry is one of the larger users of cold rolled sheet steel in the United States. Considering the supply line necessary to support a new drum plant, other employees of steel mills, ore mines, coal mines, paint companies, drum parts suppliers and other related companies would find their own jobs in jeopardy with reduced new drum production. Each new drum production position probably supports 6 to 8 jobs in supporting industries. The recession has already heavily impacted upon our industry, imagine how additional government legislation in the form of an excise tax could contribute to higher unemployment and further fueling of the recession.

Many of your own constituents are, in all likelihood, employed in the new steel drum industry. May I suggest that you contact some of these companies to obtain their reactions to H.R. 7487. Within your own state, as well as within the United States, there are more people engaged in drum manufacturing than in drum reconditioning.

The small group of reconditioners within the NABADA who support this type of legislation have been trying for 10 to 15 years to have a bill enacted that would afford a measure of competitive protection to the drum reconditioning industry. I can assure you that competitive protection legislation is not needed. Ours are very competitive businesses, we really do not need more government involvement but less. If you enact government legislation today to limit new drum production then tomorrow others may seek to control the number of new automobiles that should be built with the argument that used cars should be used longer in order to conserve natural resources, conserve energy, etc.

If one industry is successful in seeking control over its competitors through the enactment of an excise tax which would seek to control its production capability and removing from the marketplace a viable alternative for packers of products, imagine how many other industries would seek to control their competition in the same manner under the guise of one righteous cause or another.

The foregoing are my viewpoints. Many, if not most of the leaders in the drum reconditioning and new drum manufacturing industry share these same views. Our two industries are totally dependent upon each other. Without new steel drums, the reconditioning industry would cease to exist. On the other hand, without reconditioners the new drum would not be as an attractive packaging alternative for end users of steel drums. In that event, fibre and plastic containers would have made even greater inroads into both of our businesses. Clearly you can understand the relationship of one to the other. We have survived 75 years without the need of an H.R. 7487 and, in all due respect, we do not need it now.

I would respectfully request that you speak to others in the new steel drum manufacturing industry. There are also some drum reconditioners in your state and I would suggest that you talk with them further on this subject. I would hope that after fully researching the question that you would reconsider your support and sustainment of this extremely restrictive legislation.

Very truly yours,

JOHN W. CUTT,
General Manager.

H.R. 7520

A BILL To amend the Internal Revenue Code of 1954 with respect to the treatment of mutual or cooperative electric and telephone companies

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) paragraph (12) of section 501(c) of the Internal Revenue Code of 1954 (relating to list of exempt organizations) is amended—

(1) by striking out "(12)" and inserting in lieu thereof "(12)(A)",

(2) by striking out the second sentence, and

(3) by adding at the end thereof the following new subparagraphs:

"(B) In the case of a mutual or cooperative telephone company, subparagraph (A) shall be applied without taking into account any income received or accrued—

"(i) from a nonmember telephone company for the performance of communication services which involve members of the mutual or cooperative telephone company,

"(ii) from qualified pole rentals, or

"(iii) from the sale of display listings in a directory furnished to the members of the mutual or cooperative telephone company.

"(C) In the case of a mutual or cooperative electric company, subparagraph (A) shall be applied without taking into account any income received or accrued from qualified pole rentals.

"(D) For purposes of this paragraph, the term 'qualified pole rental' means any rental of a pole (or other structure used to support wires) if—

"(i) such pole (or other structure) is used by the telephone or electric company in providing telephone or electric services to its members, and

"(ii) the use of such pole (or other structure) pursuant to the rental is in connection with the transmission by wire of electricity or of telephone or other communications.

For purposes of the preceding sentence, the term 'rental' includes any sale of the right to use the pole (or other structure)."

(b) The amendments made by subsection (a) shall apply to all taxable years to which the Internal Revenue Code of 1954 applies.

Sec. 2. (a) Section 513 of the Internal Revenue Code of 1954 (defining unrelated trade or business) is amended by adding at the end thereof the following new subsection:

"(g) Certain Pole Rentals.—In the case of a mutual or cooperative telephone or electric company, the term 'unrelated trade or business' does not include engaging in qualified pole rentals (as defined in section 501(c)(12)(D))."

(b) The amendment made by subsection (a) shall apply to taxable years beginning after December 31, 1969.

SUMMARY

Present law

Rural cooperatives.—Under present law (Code sec. 501(c)(12), a mutual or cooperative telephone company qualifies for exemption from Federal income taxation only if at least 85 percent of its income consists of "amounts collected from members for the sole purpose of meeting losses and expenses." In determining whether this member-income test has been satisfied, amounts of credits accrued or received by a mutual or cooperative telephone company from other company for communications services on calls involving members of the telephone cooperative are not taken into account.

Similarly, a rural electric cooperative may qualify for exemption from Federal income taxation under Code section 501(c)(12) if it satisfies the 85-percent member-income test.[1]

Tax on unrelated business income.—Under present law, most organizations which are generally tax exempt under the Internal Revenue Code are nonetheless subject to tax on unrelated business taxable income (Code sec. 511). Thus, unless a specific exception applies, an organization which is tax-exempt (under Code sec. 501(a))[2] is subject to tax with respect to income derived from any trade or business the conduct of which is not substantially related (aside from the need of the organization for income or funds) to the exercise or performance of its exempt function.

Issues

Recently, the Internal Revenue Service has indicated that income from the rental of poles (*e.g.*, payments by a rural electric cooperative for use of a rural telephone cooperative's poles) and display listings in "Yellow Page" directories may be included in nonmember income of rural cooperatives.

The issues are whether income from pole rentals and display listings should be treated as nonmember income for purposes of the 85-percent member-income test and whether income from pole rentals should be subject to the tax on unrelated business taxable income.

Explanation of the bill

The bill would provide that, in applying the 85-percent member-income test to a mutual or cooperative telephone company, any income from qualified pole rentals or from display listings in a telephone directory is to be disregarded. Also, in applying the 85-percent nonmember-income test to mutual or cooperative electric companies, any income from qualified pole rentals is to be disregarded. Income from qualified pole rentals generally means any income from the sale of the right to use any pole (or other structure) (1) which is used by the cooperative in providing telephone or electric services to its members, and (2) use for which the pole is rented involves the transmission by wire of electricity or of telephone or other communications.

The bill also would provide that the engaging in activities which result in the receipt of qualified pole rentals is not an unrelated trade or business for a mutual or cooperative telephone or electric company. Thus, such rentals would not be subject to the tax on unrelated business taxable income.

Effective date

The amendments relating to the 85-percent member-income test would apply to all taxable years to which the Internal Revenue Code of 1954 applies.

The amendments to the unrelated business income provisions would apply to all taxable years beginning after December 31, 1969 (the general effective date of the Tax Reform Act of 1969, which applied the tax on unrelated business income to organizations exempt under Code sec. 501(c)(12)).

Revenue effect

It is estimated that this bill will reduce budget receipts by less than $5 million annually.

STATEMENT OF HON. J. J. PICKLE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

H.R. 7520

Mr. Chairman: The recent ruling of the Internal Revenue Service that would include income from the rental of poles and display listing in "Yellow Page" directories in nonmember income of the rural cooperatives has caused a number of problems. My district, the 10th Congressional District in Texas contains several rural electric cooperatives. It was one of President Johnson's proudest accomplishments that he had been instrumental in bringing electricity to the small communities and rural areas of Texas.

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[1] See Rev. Rul. 65–90, 1965–1 C.B. 242; Rev. Rul. 65–174, 1965–2, C.B. 169.

In addition, certain rural electric cooperatives in the Tennessee Valley Authority ("TVA") area are exempt from taxation under Code section 501(c)(4) even though, generally because of TVA requirements, they do not meet the 85-percent member-income test. See *U.S. v. Pickwick Electric Membership Corp.*, 158 F.2d 272 (6th Cir. 1946).

[2] In this pamphlet, references to "tax-exempt organizations" do not include social clubs (Code sec. 501(c)(7)) and employees' beneficiary associations (Code sec. 501(c)(9)), which are taxable on investment income of all types as well as unrelated business income. The term "tax-exempt organizations," as used in this pamphlet also does not include political organizations (described in Code sec. 527) and homeowners' associations (described in Code sec. 528).

This bill would provide that alowing another company to use the electric cooperative's poles will not result in an unrelated trade or business income from the rentals of those poles. It certainly makes sense to encourage the joint use of poles rather than requiring additional poles, but unless we make this clear the cooperative by renting their poles would endanger their tax exempt status.

The bill would also disregard the 85% membership income test to be disregarded in connection with a mutual or cooperative telephone company who also has display listings in the telephone directory.

The budget cost of this bill is modest, estimated at less than $5 million annually. I would recommend this bill that will help our rural electric cooperatives and our rural telephone companies.

H.R. 7553

A BILL To amend the Internal Revenue Code of 1954 to exempt from tax interest received on portfolio debt investments in United States of nonresident aliens and foreign corporations

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. PORTFOLIO DEBT INVESTMENTS IN UNITED STATES OF NONRESIDENT ALIENS AND FOREIGN CORPORATIONS

(a) TREATMENT OF CERTAIN INTEREST.—

(1) IN GENERAL.—Subsection (a) of section 871 of the Internal Revenue Code of 195 (relating to tax on nonresident alien individuals) is amended by adding at the end thereof the following new paragraph:

"(3) INCOME OF NONRESIDENT ALIEN INDIVIDUALS RECEIVED FROM CERTAIN PORTFOLIO DEBT INVESTMENTS.—No tax shall be imposed under subsection (a)(1) on interest (including original issue discount) received by a nonresident alien individual, if—

"(A) in the case of interest received from a corporation, the nonresident alien individual does not own, and is not considered as owning (within the meaning of subsection (g)), 10 percent or more of the total combined voting power (of all classes of stock entitled to vote) of such corporation, and

"(B) in the case of interest received from a partnership, the nonresident alien individual does not own, and is not considered as owning (within the meaning of subsection (g)), 10 percent or more of the capital interest, or the profits interest, in such partnership.".

(2) CONSTRUCTIVE OWNERSHIP.—Section 871 of such Code (relating to tax on nonresident aliens) is amended by redesignating subsection (g) as subsection (h) and by adding after subsection (f) the following new subsection:

"(g) CONSTRUCTIVE OWNERSHIP.—For purposes of subsection (a)(3) and section 881(c)—

"(1) OWNERSHIP THROUGH OTHER ENTITIES.—

"(A) IN GENERAL.—An interest in an entity owned, directly or indirectly, by or for a corporation, partnership, trust, or estate shall be considered as being owned proportionately by its shareholders, partners, or beneficiaries.

"(B) ATTRIBUTION FROM TRUSTS.—

"(i) In applying subparagraph (A), a trust shall be considered as owned by its beneficiaries in proportion to the actuarial interest of such beneficiaries in such trust.

"(ii) An interest in an entity owned, directly or indirectly, by or for any portion of a trust of which a person is considered the owner under subpart E of part I of subchapter J (relating to grantors and others treated as substantial owners) shall be considered as owned by such person.

"(2) ATTRIBUTION TO PARTNERSHIPS, ESTATES, TRUSTS, AND CORPORATIONS.—

"(A) TO PARTNERSHIPS AND ESTATES.—An interest in an entity owned, directly or indirectly, by or for a partner or a beneficiary of an estate shall be considered as owned by the partnership or estate.

"(B) TO TRUSTS.—An interest in an entity owned, directly or indirectly, by or for—

"(i) a beneficiary of a trust shall be considered as owned by the trust, unless such beneficiary's interest in the trust is a remote contingent interest, and

"(ii) a person who is considered the owner of any portion of a trust under subpart E of part I of subchapter J (relating to grantors and others treated as substantial owners) shall be considered as owned by the trust.

For purposes of clause (i), a contingent interest of a beneficiary in a trust shall be considered remote if, under the maximum exercise of discretion by the trustee in favor of such beneficiary, the value of such interest, computed actuarially, is 5 percent or less of the value of the trust property.

"(C) To corporations.—If 50 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such corporation shall be considered as owning the interest in an equity owned, directly or indirectly, by or for such person.

"(3) Operating rules.—

"(A) In general.—Except as provided in subparagraph (B), an interest in an entity constructively owned by a person by reason of the application of paragraph (1) or (2) shall, for purposes of applying paragraph (1) or (2), be considered as actually owned by such person.

"(B) Partnerships, estates, trusts, and corporations.—An interest in an entity constructively owned by a person by reason of the application of paragraph (2) shall not be considered as owned by such person for purposes of applying paragraph (1) in determining whether any other person is the constructive owner thereof.

"(4) Interest in an entity.—The term 'interest in an entity' means—

"(A) stock in a corporation,

"(B) an interest in the capital or profits of a partnership, and

"(C) a beneficial interest in a trust or estate.

"(5) Options.—If any person has an option to acquire stock, such stock shall be considered as owned by such person. For purposes of this paragraph, an option to acquire such an option, and each one of a series of such options, shall be considered as an option to acquire such stock.".

(3) Conforming amendment.—Section 871(a)(1) of such Code is amended by striking out "There" and inserting in lieu thereof "Except as provided in paragraph (3), there".

(b) Foreign Corporations.—

(1) In general.—Section 881 of such Code (relating to tax on income of foreign corporations) is amended by redesignating subsection (c) as subsection (d) and by adding after subsection (b) the following new subsection:

"(c) Income of Foreign Corporations Received From Certain Portfolio Debt Investments.—No tax shall be imposed under subsection (a) on interest (including original issue discount) received by a foreign corporation (other than a controlled foreign corporation within the meaning of section 957), if—

"(1) in the case of interest received from a corporation, the foreign corporation does not own, and is not considered as owning (within the meaning of section 871(g)), 10 percent or more of the total combined voting power (of all classes of stock entitled to vote) of such corporation, and

"(2) in the case of interest received from a partnership, the foreign corporation does not own, and is not considered as owning (within the meaning of section 871(g)), 10 percent or more of the capital interest, or the profits interest, in such partnership.".

(2) Conforming amendment.—Section 881(a) of such Code (relating to imposition of tax) is amended by striking out "There" and inserting in lieu thereof "Except as provided in subsection (c), there".

(c) Removal of Exemption From Tax in Case of Inadequate Exchange of Information.—

(1) Subpart C of part II of subchapter N of chapter 1 of such Code (relating to miscellaneous provisions) is amended by adding at the end thereof the following new section:

"SEC. 898. REMOVAL OF EXEMPTION FROM TAX IN CASE OF INADEQUATE EXCHANGE OF INFORMATION.

"Whenever the Secretary determines that the exchange of information between the United States and a foreign country is inadequate to identify the beneficial recipients of interest payments from sources within the United States and that such information is necessary in order to prevent evasion of taxes, the exemption from tax contained in section 871(a)(3) and section 881(c) shall not apply to any payments or payments addressed to or for the account of persons within such foreign country after the date specified in the Secretary's determination. Any such removal shall not apply to interest on obligations issued on or before the date of such determination. The removal of the exemption from tax contained in section 871(a)(3) and section 881(c) shall continue until the Secretary determines that the exchange of information between the United States and the foreign country is adequate to identify the beneficial recipients of interest payments from sources within the United States.".

(2) The table of sections for such subpart C is amended by adding at the end thereof the following new item:

"Sec. 898. Removal of exemption from tax in case of inadequate exchange of information.".

(d) Amendment of Section 2105.—Subsection (b) of section 2105 of such Code (relating to property without the United States) is amended to read as follows:

"(b) Bank Deposits and Certain Other Debt Obligations.—For purposes of this subchapter—

"(1) amounts described in section 861(c), if any interest thereon would be treated by reason of section 861(a)(1)(A) as income from sources without the United States were such interest received by the decendent at the time of his death,

"(2) deposits with a foreign branch of a domestic corporation or domestic partnership, if such branch is engaged in the commercial banking business, and

"(3) debt obligations, if any interest thereon would be eligible for the exemption from tax under section 871(a)(3) were such interest received by the decedent at the time of his death,

shall not be deemed property within the United States.".

(e) Withholding.—

(1) Nonresident aliens.—Subsection (c) of section 1441 of such Code (relating to withholding of tax on nonresident alien individuals) is amended by adding at the end of the following new paragraph:

"(9) Income exempt from tax.—No deduction or withholding shall be required under subsection (a) in the case of any item of income which is exempt from tax under section 871(a)(3).".

(2) Foreign corporations.—The last sentence of section 1442(a) of such Code is amended—

(A) by striking out "and" after "section 881(a)(4),"; and

(B) by inserting ", and the reference in section 1441(c)(9) to section 871(a)(3) shall be treated as referring to section 881(c)" after "section 881(a)(3)".

(f) Effective Date.—

(1) The amendments made by this section (other than subsection (d)) shall apply to amounts paid after the date of the enactment of this Act.

(2) The amendment made by subsection (d) shall apply to the estates of decendents dying after the date of the enactment of this Act.

SUMMARY

Present law

In general.—The United States taxes the income of U.S. citizens, residents, or corporations whether that income is from U.S. sources or abroad (in the case of foreign source income, however, a dollar-for-dollar credit is allowed for any foreign income tax paid). In the case of nonresident aliens and foreign corporations, however, the United States generally only taxes their income which is from U.S. sources.

Withholding tax on foreign investors.—In situations where the U.S. source income received by the nonresident alien or foreign corporation is interest, dividends, or other similar types of investment income, the United States imposes a flat 30-percent tax on the gross amount paid (subject to reduction in rate or exemption by U.S. tax treaties, as described below) if such income or gain is not effectively connected with the conduct of a trade or business within the United States (Code secs. 871(a) and 881). This tax is generally collected by means of withholding by the person making the payment to the foreign receipient of the income (Code secs. 1141 and 1442) and, accordingly, the tax is generally referred to as a withholding tax. In most instances, the amount withheld by the U.S. payor is the final tax liability of the foreign recipient and thus the foreign recipient files no U.S. tax return with respect to this income. If the interest, dividend, or other similar income is effectively connected with a U.S. trade or business, that income is not subject to the flat 30-percent withholding tax on gross income, but instead is included in the U.S. income tax return which must be filed for the business and is taxed at the ordinary graduated rates.

Exemptions from the withholding tax.—A number of exemptions have been provided from this 30-percent tax on gross income. Interest from deposits with persons carrying on the banking business and similar institutions is exempt (Code secs. 861(a)(1)(A) and 861(c)). Original issue discount on obligations maturing in six months or less is exempt (Code secs. 871(a)(1) (A) and (C) and 881(a) (1) and (3)). Any interest and dividends paid by a domestic corporation which earns less than 20 percent of its gross income from sources within the United States is also not subject to the 30-percent tax (Code secs. 861(a)(1)(B) and 861(a)(2)(A)). Under the expired interest equalization tax (IET), interest on certain debt obligations which were part of an issue with respect to which an election had been made for IET purposes is exempt (secs. 861(a)(1)(G) and 4912(c) of the Code).

The income of foreign governments from investments in the United States in bonds, stocks and other securities, or from interest on bank deposits, is exempt from U.S. tax (Code sec. 892). The Treasury promulgated proposed regulations under this provision on August 15, 1978. The proposed regulations, while generally allowing an exemption, would deny the exemption for income which the foreign government receives from commercial activities in the United States or income which accrues to the account of any private person. Although interest received by a foreign government might not qualify for the statutory exemption for foreign governments, such amounts might be eligible for other exemptions (such as that available for interest on bank accounts).

There is no estate tax liability with respect to a debt obligation or a bank deposit if the interest on such obligation or deposit would not be subject to the 30-percent withholding tax if it were received by the decedent at the time of his death (Code secs. 2.104 and 2.105).

Tax treaty exemptions.—In additions provided in the Internal Revenue Code, various income tax treaties of the United States provide either for an exemption or a reduced rate of tax for U.S. source interest paid to foreign persons. The exemption or reduction in rate only applies if the income is not attributable to a trade or business conducted in the United States through a permanent establishment or fixed base located in the United States. It is generally the negotiating position of the United States, as expressed in Article 11 of the Treasury's model income tax treaty, to exempt interest from withholding unless the income is effectively connected with a permanent establishment or fixed base. The treaty exemption is based on the assumption that the interest income will be taxed in the country of residency in any event. Interest generally is exempt under treaties with Austria, Denmark, Finland, Germany, Greece, Hungary, Iceland, Ireland, Luxembourg, Malawi, Netherlands, Netherlands Antilles, Norway, Poland, Sweden, U.S.S.R., United Kingdom, and Zambia. Reciprocal reductions in rate are provided under treaties with Belgium, Burundi, Canada, Rwanda, and Zaire (15 percent), Korea (12 percent), France, Japan, and Romania (10 percent), and Switzerland (5 percent).

Treaty shopping.—Although the treaty exemptions are only intended to benefit residents of the treaty country, it has been possible, as a practical matter, for investors from other countries to obtain the benefits of those treaties providing an exemption from U.S. tax on U.S. source interest income. Investors from countries which do not have tax treaties with the United States, or from countries which have not agreed in their tax treaty with the United States to a reciprocal exemption of interest (e.g., Canada and France), can effectively secure the exemption by routing their loan through a country having a treaty with the United States containing the interest exemption. This is accomplished by establishing a subsidiary, trust, or other investing entity in the treaty country which makes the loan to the U.S. person and claims the treaty exemption for the interest it receives. If the investment entity is established in the appropriate country, it may be possible for the investing entity in turn to pay the interest to the foreign investor or to a tax haven without any tax liability to the recipient and eliminating or minimizing the investing entity's tax liability with the deduction for its interest payment. This use of U.S. tax treaties by third country investors to avoid any tax on the interest income rather than to avoid a potential double tax is referred to as "treaty shopping." As discussed below, a more important treaty shopping use of U.S. tax treaties is the use by U.S. corporations of the U.S. treaty applicable to the Netherlands Antilles (and, in a few cases, the treaty applicable to the British Virgin Islands or to Luxembourg) to obtain an exemption from U.S. tax on interest paid to foreign investors on bonds issued by the U.S. corporations through Antillies (or BVI or Luxembourg) finance subsidiaries.

Reporting of interest.—U.S. corporations are generally required to file information returns to report the payment of interest (including original issue discount) of $10 or more. Nominees are also generally required to file reports with respect to interest received and passed along to the beneficial owners. One copy of the return is required to be sent to the recipient of the interest and another copy is sent to the Internal Revenue Service.

Returns are required to be made for amounts paid on corporate indbtedness if the obligation is in registerd form. The Code (sec. 6049(b)(1)(A)) also authorizes the Treasury to require reporting with respect to amounts paid on other corporate debt of a type offered by corporations to the public (e.g., a public offering of bearer bonds). However, no such reporting is presently required. Also, no information reporting is required in the case of interest of original issue discount paid to foreign investors if withholding tax is imposed on the payment or if withholding tax would be imposed but for an exemption from withholding because the amounts are eligible for a treaty exemption, the exemption for deposits with banks, because they are effectively connected with a U.S. trade or business or if certain other limitations apply. (Code sec. 6049(b)(2)(B); Treas. Reg. § 1.6049-2(b)(3)).

Withholding and identification of interest recipient.—As described above, withholding is generally required when interest is paid to a foreign investor. The Code (secs. 1441(c)(2) and 1442(a)) authorizes the Treasury to require this withholding in any situation in which the beneficial owner of securitis on which the interest is paid is unknown to the withholding agent. This authority has been exercised generally to require withholding in all such situations (Treas. Reg. § 1.1441-3(c)(4).) In addition, Form 1042S must be provided by the withholding agent to the payee when amounts have been withheld.

In order to secure a treaty exemption from U.S. withholding tax on U.S. source interest income, a foreign resident must file (or the resident's trustee or agent receiving the interest income must file on his behalf) IRS Form 1001 (Ownership, Exemption, or Reduced Rate Certificate). Form 1001 requires the disclosure of the identity and address of the owner of the bond. In the case of a bearer bond, the form must be presented to the payor by or on behalf of the foreign owner with each coupon.

Even where the foreign investor presenting an interest coupon on a corporate bond is not entitled to a treaty rate reduction or exemption, the foreign investor is nevertheless still required to present, with each such coupon, a certificate of ownership on Form 1001. (The information required by that form is described above.) Where the owner of the bond is unknown to the person presenting the coupons for payment, the regulations further provide that the first bank to which the coupons are presented for payment is to require of the payee a statement showing the name and address of the person from whom the coupons were received by the payee. (Treas. Reg. § 1.1461-1.)

Background

The Eurobond market.—A major capital market outside the United States is the Eurobond market. It is not an organized exchange, but rather a network of underwriters and financial institutions who market bonds issued by private corporations (including but not limited to finance subsidiaries of U.S. companies—see discussion below), foreign governments and government agencies, and other borrowers. In addition to individuals, purchasers of the bonds include institutions such as banks (frequently purchasing on behalf of investors with custodial accounts managed by the banks), investment companies, insurance companies, and pension funds. There is a liquid and well-capitalized secondary market with rules of fair practice enforced by the Association of International Bond Dealers. Although a majority of the bond issues in the Eurobond market are denominated in dollars (whether or not the issuer is a U.S. corporation), bonds issued in the Eurobond market are also frequently denominated in other currencies (even at times when issued by U.S. multinationals).

In general, debt securities sold in the Eurobond market are free of taxes withheld at source, and the form of bond, debenture, or note sold in the Eurobond market puts the risk of such a tax on the issuer by requiring the issuer to pay interest, premium, and principal net of any tax which might be withheld at source (subject to a right of early call in the event that a withholding tax is imposed as a result of a change in law or interpretation occurring after the obligations are issued). U.S. multinational corporations issue bonds in the Eurobond market free of U.S. withholding tax through the use of finance subsidiaries, almost all of which are incorporated in the Netherlands Antilles. Foreign issuers offer bond issues not subject to withholding tax in their home jurisdiction either through foreign finance subsidiaries (e.g., Germany) or through specific statutory exemptions. In some cases, the statutory exemptions apply to interest paid to foreign investors generally (e.g., Norway and Sweden) or, more frequently, the exception is contingent on the bond being issued in a foreign currency (e.g., Australia, Canada, and Japan). Because the Eurobond market is comprised of bonds not subject to withholding tax by the country of source, an issuer could not compete for funds in the Eurobond market if its interest payments were subject to withholding tax.

Unlike bonds issued in the U.S. capital market, Eurobonds are issued in bearer (rather than registered) form so that the interest and principal payments must be effected by presenting the coupons or bonds to a designated paying agent. Since the bonds are issued in bearer form, the anonymity of the holder of the bond is protected—the holder's identity is not disclosed to the issuer or to the government of the country of issue.

International finance subsidiaries.—Borrowing abroad (such as on the Eurobond market) by U.S. corporations is generally accomplished through the use of finance subsidiaries. Finance subsidiaries are usually paper corporations without employees or fixed assets which are organized to make one or more offerings in the Eurobond market, with the proceeds to be relent to the U.S. parent or to domestic or foreign affiliates. The interest and principal on the bonds issued by the finance subsidiary are guaranteed by its parent. Their use (described below) is intended to avoid any U.S. withholding taxes on the interest paid to the foreign bondholders.

If the money raised is to be utilized abroad, the parent corporation will sometimes form a U.S. finance subsidiary through which it issues the bonds. As noted earlier, even though the borrower (the finance subsidiary) is a U.S. corporation, interest paid by it to foreign lenders will be treated as foreign source income, and hence will not be subject to withholding, if less than 20 percent of the finance subsidiary's gross income is from U.S. sources. This gross income requirement usually is met if the U.S. finance subsidiary invests the borrowed funds in the foreign operations of the corporate group.

On the other hand, the most common practice of borrowers, particularly if the borrowed funds are to be used in the United States, is to establish a finance subsidiary in the Netherlands Antilles. This structure is designed to avoid the U.S. withholding tax by claiming the benefits of the tax treaty between the United States and the Netherlands as extended to the Antilles. The subsidiary borrows funds from foreign lenders, and the subsidiary then relends the borrowed funds to the parent or to other affiliates within the corporate group. The finance subsidiary's indebtedness to the foreign bondholders is guaranteed by the U.S. parent (or other affiliates) or is secured by notes of the U.S. parent (or other affiliates) issued to the Antilles subsidiary in exchange for the loan proceeds of the bond issue. Under this arrangement, the U.S. parent (or other U.S. affiliate) receives the proceeds of the bond issue but pays the interest to the Antilles finance subsidiary rather than directly to the foreign bondholders. Pursuant to Article VIII of the treaty, an exemption is claimed from the U.S. withholding tax on the interest payments by the U.S. parent and affiliates to the Antilles finance subsidiary. The interest payments which the Antilles subsidiary in turn pays to the foreign bondholders are not subject to tax by the Antilles. Although most or all of the income of the Antilles finance subsidiary is comprised of interest payments from its U.S. parent and affiliates, that interest income would not ordinarily be treated as effectively connected with a U.S. trade or business of the Antilles subsidiary. Consequently, since less than 50 percent of the gross income of the Antilles finance subsidiary is effectively connected with a U.S. trade or business, no part of the interest paid by the Antilles finance subsidiary to the foreign bondholders would be considered to be from U.S. sources and, accordingly, no

U.S. withholding tax would be imposed.[1] Thus, no tax is paid on the interest paid by the U.S. company to its Antilles finance subsidiary, or on the interest paid by the Antilles finance subsidiary to the foreign bondholders, either to the United States or to the Netherlands Antilles. Use of a foreign subsidiary may also increase the parent's ability to utilize foreign tax credits by converting the net income of the subsidiary into foreign source income.

Borrowings by U.S. corporations in the Eurobond market were originally a result of a program adopted by the U.S. Government during the 1960s at a time of fixed exchange rates. The program, designed to prevent the devaluation of the dollar, included several measures to encourage U.S. companies to borrow overseas, including the Interest Equalization Tax, the Foreign Direct Investment Program, the related Voluntary Foreign Credit Restraint Program, a relaxation of the no-action letter policy of the Securities and Exchange Commission with respect to foreign offerings by U.S. corporations, and the ruling policy of the IRS which encouraged foreign borrowings through finance subsidiaries. In the case of finance subsidiaries, domestic or foreign, the IRS was prepared to issue private rulings that no U.S. withholding tax applied if the ratio of the subsidiary's debt to its equity did not exceed 5 to 1 and certain other conditions were met. Numerous private rulings were issued on this basis. Finance subsidiaries were also sanctioned by a number of published rulings (Rev. Rul. 73-110, 1973—1 C.B. 454; Rev. Rul. 72-416, 1972—2 C.B. 591; Rev. Rul. 70-645, 1970—2 C.B. 273; Rev. Rul. 69-501, 1969—2 C.B. 233; Rev. Rul. 69-377, 1969—2 C.B. 231).

Following the decision by the United States to abandon the fixed exchange rate system and to allow the value of the dollar to be determined by market forces—with the consequent termination of these measures to support the dollar—Eurobond offerings by U.S. corporations decreased. This decrease was in large part due to questions as to whether finance subsidiaries qualify for the exemption from the U.S. withholding tax, questions which arose when the IRS, citing the expiration of the IET, revoked its prior rulings that properly structured finance subsidiaries would qualify (Rev. Rul. 74-464, 1974—2 C.B. 46). Because of a finance subsidiary's limited activites, the lack of any significant assets or earning power other than the parent guarantee and the notes of the parent and other affiliates, and the absence of any substantial business purpose other than the avoidance of U.S. withholding tax, offerings by finance subsidiaries involve difficult U.S. tax issues in the absence of favorable IRS rulings. Since the marketing of the bond offering is based upon the reputation and earning power of the parent, and since the foreign investor is ultimately looking to the U.S. parent for payment of principal and interest, there is a risk that the bonds might be treated as, in substance, debt of the parent, rather than the subsidiary, and thus withholding could be required. (This risk would appear to increase where, as is sometimes the case, the bonds are convertible into stock of the parent.) Compare, e.g., *Aiken Industries, Inc.*, 56 T.C. 925 (1971) and *Plantation Patterns, Inc.* v. *Commissioner*, 462 F.2d 712 (5th Cir. 1972), 72-2 U.S.T.C. ¶ 9494, *cert. denied*, 406 U.S. 1076, with *Moline Properties*, 319 U.S. 436 (1943), 43-1 U.S.T.C. ¶ 9464 and *Perry R. Bass*, 50 T.C. 595 (1968). Alternatively, the establishment of the finance subsidiary might be viewed as having as its principal purpose the avoidance of the withholding tax on the U.S. parent with the result that the exemption might not apply (Code sec. 269). Nevertheless, these finance subsidiary arrangements do in form satisfy the requirements for an exemption from the withholding tax and there are a number of legal arguments which would support the taxation of these arrangements in accordance with their form. In any event, notwithstanding the refusal of the IRS since 1974 to issue rulings with respect to Antilles finance subsidiaries, it is understood that the IRS has not to date challenged these arrangements and many bond issues have been issued since 1974 (with the number of issues increasing in recent years) on the basis of opinions of counsel.[2]

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[1] Even if the income of the finance subsidiary (the interest it receives from its U.S. parent and affiliates) were treated as effectively connected with a U.S. trade or business, the interest paid by the Antilles finance subsidiary would nevertheless be exempt from U.S. tax under Article XII of the treaty. This situation is advantageous when the taxpayer is in an excess foreign tax credit position because, while subject to U.S. tax on its net income (the spread between the interest it receives and the amounts it pays to the foreign bondholders), the finance subsidiary is not required to make an election to be subject to Netherlands Antilles tax in order to be free of the U.S. withholding tax.

[2] For detailed discussions of Eurobond financings through finance subsidiaries and of the legal issues presented, see Lederman, *The offshore subsidiary: An analysis of the current benefits and problems*, 51 Journal of Taxation 86 (August 1979), and Chancellor, *Eurobond Financings*, U. So. Cal. 1971 Tax Inst. 345 (1971).

Typically, the U.S. parent and the finance subsidiary agree to indemnify the foreign bondholder against all U.S. withholding taxes (including interest and penalties) should the IRS successfully attack the claimed exemption from U.S. withholding tax or should U.S. tax law or the tax treaty with the Netherlands Antilles be changed to eliminate the basis for the claimed exemption. Also, the bonds typically provide that if U.S. withholding tax is imposed, the bonds are immediately callable.

Table of interest paid and tax withheld.—The following table shows portfolio interest and withholding on that income for 1977, based on information returns filed with the Internal Revenue Service. The information is arranged according to the payee's country of address, which is not necessarily his country of residence.

PORTFOLIO INTEREST PAID TO FOREIGN PERSONS AND U.S. TAX WITHHELD, 1977

[Dollar amounts in thousands]

Country	Interest paid		U.S. tax withheld		Effective withholding rate (percent)
	Amount paid	Percent of total	Amount withheld	Percent of total	
Antigua	$2,970	(1)	0	(1)	0
Australia	674	(1)	$192	(1)	28.5
Bermuda	1,809	(1)	473	1.9	26.1
Belgium	9,820	1.9	1,220	5.0	12.4
Canada	129,461	25.1	9,195	37.6	7.1
France	30,150	5.8	2,785	11.4	9.2
West Germany	6,515	1.3	107	(1)	1.6
Hong Kong	1,814	(1)	313	1.3	17.3
Ireland	309	(1)	21	(1)	6.8
Italy	3,894	(1)	352	1.4	9.0
Japan	36,237	7.0	2,073	8.5	5.7
Luxembourg	4,232	(1)	129	(1)	3.1
Mexico	2,261	(1)	617	2.5	27.3
Netherlands	29,691	5.8	26	(1)	.1
Netherlands Antilles	97,026	18.8	77	(1)	.1
Panama	2,618	(1)	465	1.9	17.8
Puerto Rico	281	(1)	75	(1)	26.7
Switzerland	61,908	12.0	2,820	11.5	4.6
United Kingdom	28,359	5.6	283	1.6	1.0
United States	1,825	(1)	14	(1)	.8
Venezuela	2,356	(1)	112	(1)	4.8
Subtotal	454,290		21,349		4.7
All other countries	61,128		3,038		5.0
Total	515,418		24,432		4.7

[1] Less than 1 percent of total.

Source: Office of the Secretary of the Treasury, Office of Tax Analysis.

Legislative proposals

In connection with its consideration of the Tax Reform Act of 1976, the Committee on Ways and Means voted to repeal the 30-percent withholding tax on both interest and dividends. However, this provision was removed from the bill by the House of Representatives by a vote of 301-119. The Senate Finance Committee proposed an amendment which would have repealed the 30-percent tax on interest only. However, this amendment was deleted from the bill on the Senate floor by a vote of 54-34.

On December 15, 1979, the Senate Finance Committee reported H.R. 2297 (which, as passed by the House, would have repealed the tariff on synthetic rutile, a substance used in the refining of titanium) with several amendments, including an amendment relating to the 30-percent withholding tax on interest.[3] H.R. 7553, as introduced, is identical to the provisions of H.R. 2297 repealing the U.S. withholding tax on interest paid to foreign lenders. The provisions of these two bills are described below.

Description of provisions

Withholding tax.—Under H.R. 7553 and the Finance Committee amendment to H.R. 2297, interest paid by a U.S. borrower would generally be exempt from U.S.

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[3] Section 201 of the bill as reported; S. Rept. No. 96-504.

tax (under Code secs. 871(a) and 881) if received by a nonresident alien individual or a foreign corporation.

Interest is not entitled to the exemption from U.S. tax if it is effectively connected with the conduct by the foreign recipient of a trade or business within the United States and thus is taxed at the regular graduated rates. Also, interest is not exempt if it is paid to a foreign person having a direct ownership interest in the U.S. payor. In the case of payments from domestic corporations, direct ownership exists if the recipient of the interest owns or is considered as owning 10 percent or more of the total combined voting power of all classes of stock entitled to vote of that corporation. In the case of interest paid by a domestic partnership, direct ownership exists if the recipient of the interest owns or is considered as owning 10 percent or more of the capital or profits interest of the partnership.

To prevent U.S. persons from indirectly taking advantage of this exemption, the bills provide that a foreign corporation which is a controlled foreign corporation (within the meaning of sec. 957) is not to be entitled to the exemption for interest received from U.S. persons.

Although the bills provide an exemption for payments of interest to foreign persons, the Finance Committee stated in its report on H.R. 2297 that it does not intend to waive the information reporting requirements which would be applicable under present law to these exempt amounts. The committee further stated that it expects that regulations will be prescribed under these provisions so that the Secretary can report back to the committee the foreign persons (and their country of residence) who are receiving the benefits of this exemption.

In cases where the payor does not know the identity of the beneficial owner of the securities with respect to which the interest or original issue discount is paid, the Secretary of the Treasury may, under present law (Code sec. 1441(c)(2)), prescribe by regulations circumstances in which the payor, or any person having custody or control of the payment, will be required to withhold amounts as tax due. The present regulations require withholding where the ultimate recipient of the interest is unknown. The Finance Committee stated that it contemplates that the Secretary will exercise this authority with respect to payments of original issue discount and interest to the extent necessary to ensure that the collection of the tax imposed upon payments of interest and original issue discount to foreign persons owning a 10-percent or greater interest in the U.S. payor and to controlled foreign corporations.

Estate tax.—In the case of nonresident alien individuals, the bills also eliminate any potential U.S. estate tax liability in the case of obligations the income from which, if received by the decedent at the time of his death, would be exempt from tax.

Prevention of tax evasion.—The bills provide that if the Secretary of the Treasury determines that the United States is not receiving sufficient information from a foreign country to identify the true beneficial recipients of the interest payments and if the Secretary believes such information is necessary in order to prevent evasion of taxes, the exemption will no longer apply to payments addressed to or for the account of persons within that country for future issuances of debt obligations. The termination is to continue until the Secretary determines that the exchange of information betwen the United States and that country is sufficient to identify the beneficial recipients of the interest. Any termination of the exemption for interest will also automatically terminate the exemption from the estate tax on the debt obligations.

Effective date

The amendments providing for the income tax exemption would apply to interest paid after the date of enactment. The amendments providing for an estate tax exclusion for debt obligations would apply to estates of decedents dying after the date of enactment.

Revenue effect

It is estimated that this provision will reduce budget receipts by $36 million in fiscal year 1981, $39 million in 1982, $43 million in 1983, $47 million in 1984, and $52 million in 1985.

Issues

Capital formation and balance of payments.—Proponents of the repeal of withholding on interest argue that it would result in a considerable infusion of foreign capital into the United States, helping our balance of payments situation, strengthening the dollar, assisting in capital formation, and helping to create jobs. Repeal would permit investment in longer-term debt than the 6-month exemption for original issue discount permitted under present law. Moreover, this capital would be in the form of debt, rather than equity, and thus would not increase the extent to which U.S. businesses are controlled by foreign investors. Opponents argue that repeal is unlikely to result in any significant net increase in foreign investments in the United States but rather will result in the substitution of these obligations for other existing investments. In their view, net increases of foreign investments in the United States will depend on more fundamental factors than the repeal of a tax which can fairly easily be avoided. They also point out that, ultimately, the debt will have to be repaid, with interest, resulting in an even greater outflow of capital than was originally infused. Proponents respond by stating that, in the meantime, U.S. businesses would have enjoyed the use of the funds, on which they would presumably have earned more in income than they were required to pay out, and that once foreign funds are attracted to the U.S. debt market, there is an excellent chance that they will remain invested here indefinitely in one form or another. However, opponents respond more generally to the argument that repeal will make capital more available by pointing out that this result would apparently be directly contrary to recent steps taken to restrain the availability of credit in order to reduce inflation.

Revenue impacts.—Those in favor of repeal of the withholding tax on interest argue that there are already so many exceptions to the withholding tax that there is little point in retaining the tax in the few situations to which it does apply. In 1977, for example, only $24,432,000 was collected on $515,418,000 of portfolio interest paid to foreign taxpayers, an effective rate of 4.7 percent. Proponents of repeal argue that the repeal of withholding in the few remaining cases where it is applicable will relieve taxpayers from complying with considerable administrative burdens where the tax is not applicable and would be an important simplification. Opponents of repeal argue on the other hand that the revenue raised by the tax (an estimated $36 million in fiscal year 1981), while small in percentage terms, is nevertheless significant.

Equity arguments.—Opponents of repeal aruge that it would be inequitable to exempt foreign lenders from tax on U.S. source interest income while continuing to tax interest received by U.S. lenders. In their view, foreign lenders enjoy the income and security from investing in the United States and thus should not be exempt from paying U.S. tax on the income received, particularly since the U.S. borrowers reduce their U.S. tax by deducting the interest payments. They argue that the repeal of the tax on foreign lenders at the same time as the Administration is proposing the imposition of withholding on interest and dividends paid to U.S. taxpayers would be viewed by those U.S. taxpayers as especially unfair.

Proponents of repeal counter that the correct comparison is not with the U.S. treatment of U.S. lenders but with the way in which other foreign countries treat lenders from outside their borders (e.g., Australia, Denmark, France, Finland, Japan, the Netherlands, Norway, and Sweden, which at least in the case of bonds issued in foreign currencies, do not impose withholding taxes), since these rules determine the environment in which U.S. borrowers must compete for funds. Proponents point out that many other countries provide mechanisms for the issuance of Eurobonds free of withholding tax. Proponents claim that the equity argument is superficial because, in their view, foreign lenders will not pay U.S. tax on U.S. source interest income even if the United States continues to impose it; they will instead merely invest elsewhere.

Proponents also argue that the U.S. rule that interest paid by a U.S. person is from U.S. sources is in many instances arbitrary and that jurisdiction to tax movable capital might as easily be based on the residence of the lender. Opponents counter that such a rule would imply that no foreign tax credit should be allowed U.S. lenders on interest they receive from foreign borrowers, a result which would be strongly opposed by U.S. lenders.

Tax avoidance and evasion.—Opponents argue that if no withholding tax is imposed on interest by the country of the borrower, it would greatly increase the flow of movable capital to tax havens and bank secrecy jurisdictions, with the result that no tax would be paid on the interest to any country. In addition, because of the difficulties of enforcement, at least some of these tax-free bonds would probably be held by U.S. persons evading U.S. tax. They (opponents of repeal) argue that withholding at source is the only effective way to prevent tax avoidance and evasion. In this regard, they note that several of our major tax treaty partners have objected to the proposed repeal of the U.S. withholding tax. It is argued that repeal of withholding would undercut the long-term efforts of the United States to curb international tax evasion and avoidance, and to encourage other countries to assist in that effort. Those favoring repeal argue in response that there presently are virtually unlimited opportunities for taxpayers to evade taxes if they intend to do so and that repeal of the U.S. withholding tax on U.S. corporate bonds is unlikely to cause anyone to evade or avoid taxes who would not do so in any event. Moreover, they see as hypocritical the objections of our treaty partners because in many situations these countries permit their borrowers to pay interest to foreign lenders without withholding taxes.

Treaty negotiations.—Opponents also argue that repeal of the withholding tax would result in the surrender of a valuable "bargaining chip" available to our tax treaty negotiators. That is, if investors of a foreign country would be subjected to a 30-percent tax unless their country entered into a tax treaty with the United States, then their government would have a greater incentive to enter into a tax treaty to eliminate the tax. The United States could insist on a reciprocal concession as the price of such a provision. In that regard, opponents of repeal note that 37.6 percent of the revenue (as shown in the table) is from Canada, which recently has refused in the pending treaty negotiations to agree to a reciprocal reduction of withholding rates on interest below 15 percent. Moreover, an additional 31.4 percent of the revenue is from Switzerland, France, and Japan which also have refused to reciprocally reduce withholding rates on interest to zero. Thus, more than two-thirds of the revenue loss resulting from unilateral repeal would merely be a windfall for investors from these four countries.

On the other hand, however, those favoring repeal argue that reliance on reciprocal rate reductions or exemptions in tax treaties is arbitrarily discriminatory in the area of portfolio investment. Proponents of repeal further argue that, even if the withholding tax were repealed, other countries would still have an incentive to enter into treaties with the United Sates to reduce double taxation of income other than interest and to eliminate fiscal evasion. This is particularly true if, as in the case of the bills, the repeal is targeted so that it does not apply to interest paid to related parties. In addition, many foreign countries might prefer not to encourage their investors to export capital to the United States.

Treaty shopping.—Proponents of the repeal of the tax argue that present law has a much more deleterious effect on the tax treaty program than the loss of any possible advantages that the tax may have as a bargaining chip. In order to attract needed foreign investment, they argue, the United States must permit U.S. corporations to issue tax-free Eurobonds through finance susidiaries in the Netherland Antilles. This approval of the use of treaties by third-country nationals encourages other "treaty shopping" abuses of our tax treaty network.

Moreover, the use of finance subsidiaries to accomplish essentially the same result as repeal of the withholding tax is unnecessarily complex and expensive to the corporation issuing the bonds. Their use is expensive to the U.S. Treasury since the taxes paid to the Antilles by the finance subsidiaries are claimed by their U.S. parents as foreign tax credits.

Opponents respond that the treaty shopping abuses of the Netherlands Antilles and other treaties can be eliminated by simply revising the treaties—that if the problem is the avoidance of U.S. tax through abuses of U.S. tax treaties, repeal of the tax would not be a sensible solution to the tax avoidance.

Foreign tax credit.—Opponents of repeal also point out that if the foreign investor is from a high-tax country, he generally will be allowed a foreign tax credit for the withholding taxes paid to the United States and therefore the repeal of withholding will not provide any greater return to him which would give him a greater incentive to invest in the United States. Instead there would only be a transfer from the U.S. Treasury to his foreign country's treasury.

On the other hand, proponents of repeal point out that if the investor is from a low-tax country, repeal of withholding generally would make a difference to him. Also, there are significant accumulations of wealth held by pension trusts in developed countries which may be entirely exempt from foreign tax. In addition, if a foreign financial institution is subject to the 30-percent U.S. withholding tax on gross income rather than the regular net income tax because it leads into the United States from a foreign office, the U.S. tax will probably exceed its foreign tax on the income. In both of these cases, repeal of U.S. withholding would also provide a positive incentive to invest in the United States (although, as opponents argue, there is no reason the elimination of U.S. tax cannot be targeted to these limited classes of foreign persons through a narrow Code amendment or through a reciprocal treaty exemption). Also, depending on the mechanism his foreign country has adopted for estimated tax payments, he may lose the use of the amount withheld for the period between the time the U.S. tax is withheld on the interest and the time he can secure a credit from his government.

Foreign banks.—Under present law and Treasury regulations, foreign banks are subject to the regular U.S. corporate income tax if they book the loans through U.S. branch offices, but if they book loans to U.S. borrowers through a foreign branch, they are subject to the 30-percent U.S. gross withholding tax (unless a treaty rate reduction or exemption applies). Repeal of the withholding tax would make it possible for foreign banks to lend to U.S. borrowers from nontreaty tax haven countries without payment of either the regular corporate tax or the withholding tax. This tax exemption, together with their exemption from reporting requirements and reserve requirements applicable to U.S. banks and recently extended to U.S. branches of foreign banks, would provide to these foreign banks operating from offshore a competitive advantage over U.S. banks and U.S. branches of foreign banks and, in addition, would reduce the Federal Reserve's control over the banking system. Proponents of repeal question whether, as the result of repeal, foreign banks would begin booking their U.S. loans from offshore to any significant extent. They point out, for instance, that in many cases foreign banks at present can lend into the United States from many treaty countries without any U.S. tax, yet there does not appear to be any significant activity in this regard. They argue, moreover, that offshore booking, if it were to occur, would not so much be caused by the repeal of the withholding tax but rather by the rules treating interest income derived by banks and other financial institutions as not effectively connected with a U.S. trade or business as long as it is booked through a foreign branch, and they maintain that this is an unrelated problem which can be separately resolved, if deemed appropriate, by amending the Code or the regulations.

The U.S. withholding tax as a protective tariff.—Those favoring repeal argue that the U.S. withholding tax on interest paid to foreigners in effect operates as a protective tariff. Its principal impact is to prevent foreign investors from buying U.S. corporate bonds, and therefore they do not pay the tax. As a protective tariff, it simply keeps foreign private capital out of our bond markets and does not raise significant revenue. Opponents of repeal contest the characterization of the tax as a protective tariff. In their view, a protective tariff is a levy imposed on the importation of goods or services which would not be imposed if the goods or services were produced locally. The withholding tax imposed on foreign lenders, in contrast, is comparable to, and in lieu of, the income tax imposed on U.S. lenders, and it is not designed to discourage foreign persons from buying U.S. corporate bonds but merely to subject them to a tax comparable to the tax paid by U.S. bondholders. The fact that the tax is not analogous to a protective tariff, it is argued, can be demonstrated by the fact that the U.S. tax does not result in any net increase in the foreign bondholder's aggregate worldwide tax burden, and thus does not discourage investors from buying U.S. corporate bonds, as long as the bondholder is willing to report the U.S. interest for tax purposes in his home countries and claim a credit for the U.S. tax.

Foreign policy aspects.—As previously noted, one of the principal methods for the avoidance of U.S. withholding taxes on corporate obligations is the use of Netherlands Antilles finance subsidiaries. This results in considerable financial activity in the Antilles. The Antilles government has argued against repeal of the general withholding requirement in the Code on the ground that it would no longer be necessary to route borrowings through the Antilles, and the use of the Antilles as a financial center would be substantially reduced. The Antilles government has estimated that the offshore financing activities generate between $40 million and $44 million in revenues, amounting to 25 to 30 percent of the Antilles federal budget. To insure the stability of the Antilles, the United States might find it necessary to replace a considerable part of these revenues with foreign aid.

Proponents of repeal point out, however, that the need to route transactions through the Antilles adds needlessly to the cost of borrowing. The same business that now generates jobs in the Antilles could be used to generate more financial jobs in the United States. Because of the availability of the foreign tax credit, some of the revenues collected by the Antilles may in effect already come out of the U.S. Treasury through reduction of the U.S. tax burden on the U.S. parent of an Antilles finance subsidiary. Further, proponents of repeal argue that it is illogical from a foreign policy standpoint for the U.S. contribution to a Caribbean country's economy to be determined by that year's volume of Eurobond offerings.

Disclosure requirements

The Senate Finance Committee report makes it clear that the committee intends that the information reporting requirements of present law remain in effect with respect to interest exempt from withholding tax. In addition, the report points out that, under present law, the Treasury is authorized to require withholding where the payor of the income does not know the owner of the securities on which the interest is paid. The committee report states that this authority is to be used to ensure the collection of tax where interest is paid to direct investors or CFCs.

Those who oppose the interest reporting requirement contend that it does not comport with the realities of the Eurobond marketplace and therefore would nullify any beneficial effect of the repeal of withholding. They point out that Eurobonds issued by competing borrowers from other countries do not require withholding, are free of reporting requirements, and are typically in bearer, rather than registered form. A requirement that the lender report his identity to qualify for exemption from withholding would impose an administrative burden on lenders and could also raise some doubt in the minds of the lenders as to whether the obligations in their hands qualified for exemption from withholding. Those arguing that the disclosure requirements should be deleted from the bill argue that the loss of anonymity would make it impossible, as a practical matter, to market the obligations of U.S. borrowers to those foreign investors who are unwilling to have their identities disclosed to the IRS.

Those who support the information reporting requirements argue that, without these rules, it would be simple for direct investors and foreign subsidiaries to avoid the limitations on the exemption from withholding. It would be possible, although difficult, to track down interest income paid to foreign subsidiaries through the Internal Revenue Service audit process. Many U.S. shareholders of CFCs would never be audited. It would generally not be possible to audit foreign direct investors. Additionally, those supporting reporting requirements argue that their absence would assist U.S. persons to evade U.S. tax by investing anonymously in bearer obligations abroad. They argue further that the principal reason foreign holders of bearer bonds would refuse to disclose their identities to the IRS is that they are evading taxes and currency control requirements of their own countries. They argue further that a decision by the United States not to require the reporting of the identity of the beneficial owner in order to increase the marketability of bonds issued by U.S. companies would be contrary to the U.S. policy not to condone foreign fiscal fraud (as expressed, for example, in the Code rules added by the Tax Reform Act of 1976 denying foreign tax benefits when foreign officials are bribed) and contrary to the spirit of our tax treaty exchange of information obligations.

Foreign subsidiaries (controlled foreign corporations)

The bills do not provide an exemption for interest paid to controlled foreign corporations (CFCs)[4] on the grounds that there are a number of ways in which such an exemption could result in undue tax advantages. If CFCs could receive interest income free of withholding tax, U.S. tax on that income could be deferred indefinitely if the CFC also had an active business. Alternatively, if the U.S. parent had excess foreign tax credits from unrelated foreign business operations, the interest could in effect be repatriated to the parent tax-free. Finally, even if neither of these fact patterns applies and the interest income of the foreign subsidiary is currently taxable to the U.S. parent under subpart F without being fully offset by foreign tax credits, the U.S. parent could benefit by being able to invest pre-tax dollars in U.S. debt obligations rather than only the amount remaining after imposition of U.S. tax. Each of these possibilities is explained in greater detail below.

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[4] Generally, a foreign corporation is a CFC if more than 50 percent of the voting power is held by "United States shareholders," that is, U.S. persons each of whom holds 10 percent or more of the voting power.

In the case of a controlled foreign corporation (CFC), subpart F (secs. 951–64 of the Code) provides that in general the United States shareholders must currently include in their income certain types of tax haven income of the corporation and certain types of passive investment income, including interest income. However, no inclusion is required if these types of income amount to less than 10 percent of the gross income of the corporation. Most corporations with active businesses abroad are eligible for this exception because the *gross* income from their business activity is generally more than 90 percent of total gross income even though their net investment income may be a larger proportion of their overall net income because of greater expenses associated with the active conduct of a business.

Advantages could exist for the U.S. shareholder of a CFC even if the shareholder were required to report the interest income currently. For example, suppose that a U.S. parent company has excess foreign tax credits.[5] If the U.S. parent company lent money directly to a U.S. borrower, the U.S. parent would, of course, be taxable on the interest income. However, if the U.S. parent makes the loan through a foreign subsidiary (a CFC), the U.S. parent may, in effect, receive the income tax-free. The U.S. source interest income could (in the absence of U.S. withholding) be received by the subsidiary free of U.S. tax. The only tax paid by the subsidiary would be the tax imposed by the country in which it is received, which may be considerably lower than the U.S. tax rate paid by the parent.[6] When this interest income of the subsidiary is taxed to the U.S. shareholder under subpart F as an actual or constructive dividend, the dividend may be treated as foreign source income, because the CFC is a foreign corporation, even though the interest income received by the CFC was from U.S. sources. Thus, U.S. source income (the interest) may in effect be converted into foreign source income (the dividend). This increases the U.S. shareholder's foreign tax credit limitation and may permit the taxpayer to use its excess foreign tax credits from its unrelated foreign active business operations (which might otherwise expire unused) to offset completely its U.S. tax on the income, allowing the U.S. interest income to be received without imposition of any U.S. tax.

A. U.S. shareholder of the CFC may obtain tax advantages from repeal of the withholding tax even if the shareholder is not in an excess foreign tax credit position. If the CFC has accumulated earnings abroad which are not subpart F income, it could not repatriate them without paying U.S. tax on the dividend income.[7] The U.S. shareholder could then reinvest only the after-tax account of the dividend in obligations of U.S. companies. However, if the income is not repatriated, the CFC could invest the pre-tax amount of earnings (which, if foreign income taxes are low, could be considerably larger than the amount which would remain after U.S. tax) in obligations of U.S. companies. Thus, although the U.S. parent would be subject to current U.S. tax on the interest income earned by the foreign subsidiary under subpart F (unless the 10-percent *de minimis* rule described earlier applied), the subsidiary would have had a larger amount available to invest, and thus would receive more income, than the U.S. parent would have had if the funds had been repatriated to it as a dividend. This could be attractive if the subsidiary were not also burdened with a withholding tax on interest received. While this would be attractive even where the higher amounts of interest income of the CFC are currently taxable to the U.S. parent under subpart F, it is particularly attractive where, on account of the 10-percent *de minimis* rule, the interest is not subpart F income taxable to the U.S. parent.

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[5] The United States taxes domestic taxpayers on their worldwide income, but allows a credit against its tax for foreign income taxes. The credit allowable in any year is limited, however, by a formula which is generally intended to allow the foreign tax credit to be used only to offset the U.S. tax paid on the taxpayer's foreign source income, not the tax on its U.S. source income. Generally, the limitation is equal to the taxpayer's pre-credit U.S. tax multiplied by a fraction, the numerator of which is the taxpayer's foreign source taxable income and the denominator of which is the taxpayer's worldwide taxable income. A taxpayer whose foreign income taxes are greater than this limit is said to have excess tax credits. The excess credits may be carried back 2 years and forward 5 years to be utilized in years in which the taxpayer's foreign tax credit limitation formula exceeds foreign income taxes actually paid. However, if the excess credits cannot be used in any of these years, they are lost forever. Many taxpayers find that, because of high foreign tax rates, they are chronically in an excess credit position.

[6] If the tax paid on the interest to the foreign country in which it is received is at least equal to the U.S. rate of tax, then the parent would have no incentive based on this analysis to structure the loan through the foreign subsidiary. However, if it did so, the parent would still pay no U.S. tax, so the net result would be a transfer of funds from the U.S. Treasury to the foreign country's treasury.

[7] This assumes that the U.S. shareholder would not be entitled to an indirect foreign tax credit (for taxes paid by the CFC on its income) which would eliminate U.S. tax on the dividend.

Those who favor extending the repeal of the withholding tax to interest paid to CFCs point out in this last situation that discouraging the CFC from investing in debt of U.S. obligors is contrary to the policy expressed by Congress in the Tax Reform Act of 1976. Prior to the amendments made by that Act, U.S. shareholders of CFCs were treated as receiving a dividend from the CFC whenever the CFC invested in "U.S. property," including debt obligations of U.S. persons. This rule was adopted because it was felt that reinvestment of the funds in the U.S. was a repatriation essentially equivalent to a dividend. However, the 1976 Act changed this rule to permit portfolio investments in the United States without imposition of current tax under subpart F. Thus, CFCs were no longer encouraged by subpart F to reinvest earnings abroad, rather than in the United States. It was believed that this would improve the U.S. balance of payments by encouraging capital inflow from CFCs into the United States. Proponents also point out that, if a U.S. withholding tax is imposed on interest received by a CFC, and the U.S. tax on dividends from the CFC is not eliminated by the foreign tax credit, double taxation of the income will result. That is, the income will be taxed once by the U.S. when paid to the CFC and will be taxed a second time when paid as a dividend by the CFC to the U.S. shareholder.

HOUSE OF REPRESENTATIVES,
COMMITTEE ON GOVERNMENT OPERATIONS,
COMMERCE, CONSUMER, AND MONETARY AFFAIRS SUBCOMMITTEE,
Washington, D.C., June 18, 1980.

Hon. DAN ROSTENKOWSKI,
U.S. House of Representatives,
Washington, D.C.

DEAR DAN: I am writing to you in your position as chairman of the Subcommittee on Select Revenue Measures, Committee on Ways and Means. As you know, this Thursday, June 19, 1980, your subcommittee will be considering H.R. 7553, to amend the Internal Revenue Code to exempt from Federal taxation interest received by foreign investors on their U.S. portfolio debt investments. I am opposed to this bill.

The Subcommittee on Commerce, Consumer and Monetary Affairs, which I chair, has been conducting a lengthy investigation into the operations of Federal agencies relating to foreign investment in the United States. Pursuant to that investigation, we have closely followed U.S. tax policy on this subject and have reviewed internal agency documents relating to the 30 percent withholding proposal.

The subcommittee's investigation convinces me that H.R. 7553 should not be enacted: It is inequitable and unfair to U.S. taxpayers; it will distort international markets; it may be detrimental to U.S. domestic capital markets; and it could foster international tax evasion.

I am enclosing a statement which explains my opposition to H.R. 7553. I respectfully offer it for your consideration.

Sincerely,

BENJAMIN S. ROSENTHAL,
Chairman.

Enclosure.

STATEMENT OF HON. BENJAMIN S. ROSENTHAL, CHAIRMAN, COMMERCE, CONSUMER, AND MONETARY AFFAIRS SUBCOMMITTEE, COMMITTEE ON GOVERNMENT OPERATIONS

The Subcommittee on Commerce, Consumer, and Monetary Affairs, which I chair, has been examining for almost two years (involving 10 days of hearings) Federal agency operations relating to foreign investment, including efforts by Federal credit and banking agencies to market their securities abroad. A review of their internal documents shows that several years ago the Federal Home Loan Bank Board (FHLBB), including the Federal Home Loan Mortgage Corporation, began to consider ways to market their debt securities to foreign investors. It appears that foreign investors were receptive but that the withholding tax eliminated "any serious interest" on their part. As a result, the Farm Credit Administration (FCA), the Federal National Mortgage Association (FNMA), and the FHLBB concluded that, without removing the withholding requirement, they could not attract Eurodollars by selling their securities to foreign investors. After deciding to "stay in the background," they undertook to convince Treasury to initiate the legislative proposal to repeal the 30 percent withholding tax as applied to interest paid to foreign investors.

Before this committee today is that legislative proposal, H.R. 7553. This bill would eliminate the withholding tax on interest paid to foreign investors on all debt securities and bank deposits. Not only would this provide an overly generous preference for some, it would provide an unwarranted loophole for many others, whom it is not intended to benefit.

I oppose H.R. 7553 because, by giving preferential treatment to and subsidizing the investment of foreigners, it is unfair to American taxpayers. It is also inefficient. It may also be detrimental to our domestic capital markets by impeding Federal Reserve (Fed) and administration policies to restrict the money supply. It will distort international capital markets. It could facilitate tax evasion abroad as well as at home.

This proposal would subsidize nonresident aliens by making the interest paid on debt issues tax exempt, while continuing to tax U.S. citizens on similar debt issues. Last year the Senate Finance Committee reported out a bill (H.R. 2297) to tax capital gains earned by foreigners from the sale of real property. Section 201 of that bill, which is the same as H.R. 7553, would repeal the 30 percent withholding tax. The report accompanying that bill states, with regard to the capital gains: "The Committee believes that it is essential to establish equity of tax treatment in U.S. real property between foreign and domestic investors . . . (T)he committee believes the U.S. should not continue to provide an inducement through the tax laws for foreign investment * * *." I find it anomalous that while Congress is attempting to end preferential treatment for a foreign investor who has capital gains on real estate, it is now asked by the administration to create preferential treatment for a foreign investor who has interest income. Moreover, if the administration's proposed 15 percent withholding of interest and dividend payments to U.S. taxpayers is enacted, this inequity will be even greater.

The tax "subsidy" which would result from this proposal is similar in every way to an outright grant of money. In recent testimony before my subcommittee on energy tax policy,[1] the administration outlined its position in this regard.

"One point which is frequently overlooked and which is very important is that a proposal for a tax expenditure through a special credit, tax-exempt financing, a special deduction, is a choice among a number of programs which can achieve the same objective.

"The tax system is a means of delivering a Federal subsidy but it is only one of several means." [2]

The Administration spokesman made clear that the Treasury Department opposes these tax subsidies, because they are a less cost-efficient way to address the problem involved. Based on the administration's own policy statements, H.R. 7553 is an inefficient way to increase the marketability of U.S. debt instruments abroad.

According to a recent "Treasury Bulletin" foreigners own over $250 billion in U.S. debt securities (both public and private). Federal banking agency documents available to the Subcommittee on Commerce, Consumer, and Monetary Affairs indicate that between 10–20 percent of FHLBB, Fannie Mae, FCA and GNMA securities are currently held by foreigners. What our Federal financial institutions seek to do with this legislation is to increase these figures dramatically. Yet, we simply do not know the impact—both political and economic—of so much of our debt being owed to foreign investors.

More serious is the possible impact of this Eurodollar borrowing on the U.S. domestic money supply, inflation, housing policy, etc. On Tuesday, March 18, 1980, the Wall Street Journal noted in an editorial that the Federal budget "greatly understates the Government's impact on the economy," in good part because of Federal agency recourse to the private capital market. These impacts are unknown. However, they deserve further study and consideration before Federal banking agencies are, in effect, permitted to sell tax-exempt securities abroad, greatly increasing the U.S. money supply.

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[1] Hearings before the Subcommittee on Commerce, Consumer, and Monetary Affairs of the House Government Operations Committee, "Interrelationship Between U.S. Tax Policy and U.S. Energy Policy," Mar. 13, 1979, Washington, D.C., 1979.

[2] Hearings, pp. 86–87.

These agencies contend that they cannot compete with issues already in the international marketplace because prevailing interest rates for private debt securities are too high. However, by making the U.S. issues tax exempt to foreigners, the U.S. issues would seek to attract capital away from other competing issues. Considering the magnitude of these debt issues, the distortion that would be created in the international capital markets could be severe.

The United States has worked hard through bilateral tax treaty negotiations to develop a balanced tax structure. If this delicate balance is disturbed by making the United States a tax haven country for foreign capital, then some of our foreign trading partners may react. For example, this past summer the United States, in an effort to achieve its goal for heating fuel oil, subsidized imports by $5/barrel. The European markets responded by increasing the price of heating oil by $5/barrel. The net effect was merely higher prices. A similar reaction in the international capital markets may not provide the United States additional capital but it will increase the price Americans pay for the use of capital. In any event, as I understand, several foreign governments opposed this repeal of the 30 percent withholding in 1976, when it was proposed then. Their present positions on this issue might be solicited by this committee.

Nonresident aliens, who are subjected to some U.S. withholding tax on interest paid, are generally entitled to claim the U.S. tax paid as a credit against their taxes due in their own countries. Presumably, the total tax paid will remain the same. It should be a matter of indifference as to which country the foreigner pays his taxes, as long as the amount of tax due does not change. One must wonder, therefore, why a foreign investor who can claim a tax credit at home wants to abolish the withholding tax here.

Internal FHLBB documents provide an answer by showing that many proposed investors want to remain anonymous. Under current law, however, they cannot, because they must reclaim from the IRS the excess withholding (created by lower treaty rates). In a letter to the FHLBB, one knowledgeable broker observed:

"* * * potential investors would need to identify themselves and their domicile to the Internal Revenue Service through filing Form 1001 to reclaim interest withheld. Furthermore, many of the countries with zero withholding tax treaties impose foreign exchange or other limitations which would significantly reduce investor demand from these countries.

"It would therefore not be possible to distribute Eurosecurities on behalf of a U.S. government agency in the usual manner nor to maintain an active secondary market."

In good part this appears to be the motivation for many investors who are pressing the Federal banking agencies and the Treasury for elimination of section 898 of the present bill. The present proposal, without the requirement for identifying nonresident aliens, (Sec. 898), could facilitate income tax evasion and foreign exchange violations abroad—a problem which would undoubtedly upset many of our foreign allies.

In any event, I feel that 898 will not work or be effectively enforced, despite its efforts to require Treasury to take steps to determine beneficial ownership and to share that information with other countries. Based on my subcommittee's investigation, I doubt that any method to enforce the identification of beneficial ownership can be effectively devised and implemented without strong penalties, including forfeiture. These are presently lacking.

I am compelled to conclude, therefore, that foreign investors who originally pushed for this exemption may not pay taxes here or abroad, notwithstanding Section 808 of the bill.

AMERICAN BAR ASSOCIATION,
Washington, D.C., July 3, 1980.

HON. DAN ROSTENKOWSKI,
Longworth Building,
Washington, D.C.

DEAR CONGRESSMAN ROSTENKOWSKI: As you know, the Section of Taxation has a vital interest in H.R. 7553. However, the Section was unable to meet American Bar Association requirements in time to testify before the Subcommittee on Select Revenue Measures on June 19.

Nevertheless, enclosed is a statement of the views of the Section, submitted for the official record of the June 19 hearings. These views are those only of the Section of Taxation and should not be construed as those of the American Bar Association. Neither the House of Delegates nor the Board of Governors of the Association has considered the matter, and no position has been developed. Thank you for your consideration.

Sincerely,

EDWARD N. DELANEY,
Vice-Chairman, Government Relations.

STATEMENT OF THE SECTION OF TAXATION, AMERICAN BAR ASSOCIATION

INTRODUCTION AND SUMMARY OF COMMENTS

The report discusses the proposal which would repeal the withholding tax on portfolio interest paid to nonresident aliens and foreign corporations. The report consists of (1) a summary of the current proposal of the Senate Finance Committee, (2) a discussion of the background of the proposal, and (3) technical comments on the proposal.

The Section of Taxation has not taken a position in favor of, or in opposition to, the proposal—primarily because the judgments to be made relate more to economic policy, such as the U.S. balance of payments and domestic credit conditions, than to law. However, the technical comments set forth below may be summarized as follows:

(1) The proposal's application to foreign payors as well as U.S. payors of interest is sound.

(2) The proposal's portfolio test should be abolished altogether, extending the exemption to all foreign investors, whatever the degree of ownership of the payor.

(3) It would be preferable to draft the proposed constructive ownership rules by cross reference to section 318, either with an indication of the differences or with no changes.

(4) Controlled foreign corporations should not be excluded from the benefit of the exemption, although this view is not unanimous among the members commenting on the proposal.

(5) The removal of the withholding tax exemption under the current proposal in the case of an inadequate exchange of information will have limited usefulness, and is inconsistent with the goal of allowing obligations of U.S. corporations to trade freely in international capital markets.

(6) The reporting requirements which are contemplated probably prevent the proposal from realizing its general purpose, because the likely procedure would represent such a deterrent to purchase of the obligations that, in most cases, domestic or foreign finance subsidiaries would continue to be utilized as under current law.

SUMMARY OF THE PROPOSAL

H.R. 2297, as it passed the House of Representatives on September 10, 1979, would have suspended duties on synthetic rutile for the period June 30, 1979 through June 30, 1982. The Senate Finance Committee reported an amended bill on December 15, 1979, after deleting the provision relating to the suspension of duties on synthetic rutile and adding several provisions, including the repeal of the tax on interest paid to certain foreign investors (Section 201 of H.R. 3397).

Present law provides, in general, that interest, dividends and other similar types of income of a nonresident alien or a foreign corporation are subject to a 30 percent tax on the gross amount paid, unless the income is effectively connected with the conduct of a trade or business within the United States. The tax is collected by withholding.

Under the Senate Finance Committee proposal, interest (including original issue discount) would generally be exempt from U.S. tax if received by a nonresident alien individual or a foreign corporation. Interest would not be entitled to the exemption if the interest were effectively connected with the conduct of a trade or business within the United States or if the interest were received by a foreign person having a 10 percent or greater ownership interest in the payor. In the case of a corporate payor, the test would be 10 percent or more of the total combined voting power of all classes of stock entitled to vote. In the case of a partnership payor, the test would be 10 percent or more of the capital interest, or the profits interest, in the partnership. The proposal would provide special constructive ownership rules. A foreign corporation which is a controlled foreign corporation would not be entitled to the exemption.

The proposal would also repeal the estate tax on debt instruments held by a nonresident alien individual if any interest received by the decedent at the time of death would be eligible for the income tax exclusion.

Under the proposal, if the Secretary of the Treasury or his delegate determines that the United States is not receiving sufficient information from a foreign country to identify the true beneficial recipients of the interest payments, and if the Secretary believes such information is necessary in order to prevent evasion of taxes, the exemptions would no longer apply to payments addressed to or for the account of persons within that country for issuances of debt obligations after a date specified by the Secretary or his delegate.

The new interest exemption would apply to interest paid after the date of enactment. The estate tax exclusion would apply to estates of decedents dying after the date of enactment.

The Senate Finance Report estimated that the provision would reduce budget receipts by $17 million in fiscal 1980 (ending June 30), $36 million in fiscal 1981, $39 million in fiscal 1982, $43 million in fiscal 1983, and $47 million in fiscal 1984. The revenue estimate evidently assumed enactment in January of 1980 and assumed that the new interest exemption would not increase foreign borrowing.

BACKGROUND

The 30 percent withholding tax on interest, dividends and other similar income has been in force since 1918, with the rate unchanged since 1942.[1] The current proposal for repeal of the withholding tax on portfolio interest has its origin in 1974 when, in response to urging by the Nixon administration, the House Ways and Means Committee made a tentative decision to repeal the 30 percent withholding tax on portfolio interest *and dividends* paid by United States persons to foreign persons.[2] No bill was reported out in 1974, however.

H.R. 10612, the proposed Tax Reform Act of 1976, as reported by the House Ways and Means Committee on November 12, 1975, set forth the proposal in statutory language. This proposal was similar to, but broader than, the current proposal.

With respect to interest, the Committee Report stated that the change was "in order to enable U.S. borrowers to obtain funds for their domestic as well as foreign capital needs." The Committee indicated that it believed that the imposition of a withholding tax on obligations issued by U.S. persons can impair the ability of U.S. corporations to raise capital in foreign markets. The Committee stated that the lack of a broad exemption has in some cases made it difficult to trade U.S. obligations in international bond markets.

The Committee explained the reason for the dividend exemption by stating its "belief that this will assist the recovery of the U.S. economy by making U.S. investment more attractive to foreigners and will further assist in the recycling of petrodollars."

The exemptions did not apply if foreign persons owned or were considered as owning more than 50 percent of the total combined voting power of all classes of stock entitled to vote of a payor corporation (or more than 50 percent of the capital or profits interest of a payor partnership) and if the recipient owned or was considered as owning 10 percent or more of such voting power (or 10 percent or more of such capital or profits interest).

This provision was deleted by amendment on the floor of the House of Representatives immediately before the bill was passed by the House on December 4, 1975. The vote was 103 in favor, 119 opposed, and 14 abstaining. The Senate Finance Committee reinstated the provision in the bill which it reported out on June 10, 1976. However, its version was limited to interest. This provision was deleted by amendment on the floor of the Senate immediately before the bill was passed by the Senate on July 26, 1976.

The amendment was approved 54–34.

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[1] Prior to 1942, the rate varied considerably. It was generally substantially lower, particularly for individuals. See 8A Mertens, the Law of Federal Income Taxation, § 47B.19 and § 47B.33.

[2] Tax Reform Act of 1974: Tentative Decisions of the Ways and Means Committee Corresponding to Section of Draft Bill prepared for the use of the Committee on Ways and Means by the staff of the Joint Committee on Internal Revenue Taxation (Nov. 18, 1974).

The current committee report gives the same reasons for the bill, using the same language, as the House and Senate reports did in connection with the 1975 and 1976 bills.

TECHNICAL COMMENTS

Nationality of the Payor.—The 1975 and 1976 bills provided an exclusion from gross income under IRC §§ 872(b) and 883 which were applicable only if the payor were a United States person.[3] The limitation to U.S. payors would have had an inherently discriminatory effect, since U.S. branches of foreign corporations would not have had the same access to foreign capital markets.[4] The 1979 proposal would solve this problem by amending IRC §§ 871 and 881 (instead of IRC §§ 872(b) and 883) to provide that no tax is imposed on portfolio interest. This provision would be automatically applicable to foreign payors as well as U.S. payors.

The Section of Taxation approves of change. U.S. tax law should not discriminate against foreign corporations. Violations of this principle would be bad tax policy and would be inconsistent with general U.S. efforts to achieve nondiscrimination.

Portfolio Test.—The 1975 and 1976 bills denied the exemption when two conditions were met. First, the voting power of a corporate payor (or the income or capital interest of a partnership payor) had to be more than 50 percent owned by foreign persons. Second, the recipient taxpayer had to own at least 10 percent. The current proposal drops the first condition.

In the view of the Section, the portfolio test should be abolished altogether, extending the exemption to all foreign investors, whatever the degree of their ownership of the payor. If repeal of the withholding tax can be justified on tax policy grounds, and if it is viewed as appropriate in order to encourage investment in the United States, the same reasoning applies equally well no matter how much stock is owned by the investor.

Presumably the portfolio test was proposed in order to prevent U.S. corporations controlled by foreign direct investors from taking advantage of both an interest deduction against U.S. corporate tax and an exemption from U.S. withholding tax. If this is so, the portfolio test of the 1975 and 1976 bills seems more appropriate than the portfolio test of the current proposal. Although a 10 percent ownership interest can often result in working control for day-to-day issues, it results in little or no control when other ownership is concentrated, and does not result in significant control when the issues are significant enough to obtain the attention of other investors.

Moreover, retention of the first condition would substantially lessen the burden on the payor. The Section substantially believes that, if a portfolio test should be retained, the 50 percent rule should be included in the test. Most publicly-held U.S. corporations believe with some confidence that not more than 50 percent of their voting power is owned by foreign persons. However, they would have trouble verifying that any particular share of voting stock is not owned by a foreign person which owns or constructively owns more than 10 percent of the voting power. To some extent this problem can be alleviated by withholding tax regulations which excuse a withholding agent which relies upon a certification by the recipient that he owns less than 10 percent. However, such a certification procedure is inconsistent with current practice in the Eurobond market.

Constructive Ownership Rules.—The constructive ownership rules contained in the current proposal are the same as those contained in the 1976 bill, which were the same as those contained in the 1975 bill except for the addition in 1976 of a special rule concerning options. The Section has no substantive problem with the details of those rules. However, it would seem preferable to adopt an existing set of constructive ownership rules by cross reference.

The proposed rules are essentially the same as the rules set forth in section 318 except that (1) the proposed rules have no family attribution and (2) section 318 treats ownership by a corporation as ownership by its shareholder only if such shareholder owners 50 percent or more in value of the stock of such corporation. However, substantially different language is used. The Section believes that it would be preferable to draft the proposed rules by cross reference to section 318, with an indication of the differences, as is done in section 958(b). It would be even more preferable to adopt the rules of section 318 with no changes. The constructive ownership rules are arbitrary, and a new arbitrary set should not be adopted unless there are compelling reasons to do so.

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[3] The Senate Finance Committee Report, in describing the current proposal, indicates that the current proposal has the same limitation. Clearly, however, it does not.

[4] This assumes that the definition of U.S. person in IRC § 7701(a)(30) does not include a foreign corporation doing business in the United States. But cf. Treas. Reg. § 301.7701–5.

The Controlled-Foreign-Corporation Exclusion.—The Section believes that controlled foreign corporations should not be excluded from the benefit of the exemption, although this view is not unanimous. Current law already effectively prevents loans to related U.S. persons; such loans are treated as investments in United States property which result in an end to deferral under subpart F. The Tax Reform Act of 1976 amended IRC § 956(b)(2)(F) to encourage controlled foreign corporations to lend to unrelated U.S. persons. Excluding them from the current proposed exemption would have the opposite effect.

The exclusion points out a technical problem with the foreign tax credit provisions. Under current law, if a controlled foreign corporation earns U.S. interest income subject to a withholding tax, there is double taxation. When the income is distributed to the shareholder, it is taxed again. A credit is given to 10 percent or greater corporate shareholders for foreign taxes paid by the controlled foreign corporation, and but not for U.S. taxes. The foreign tax credit provisions should also give credit for U.S. taxes.

Inadequate Exchange of Information.—The removal of the exemption in the case of an inadequate exchange of information is essentially the same in the current proposal as in the 1975 and 1976 bills.

No reason for this provision is given in the Committee Reports. Presumably the provision is intended to help the Internal Revenue Service audit the conditions of the exemption, i.e., (1) the portfolio test and (2) the prohibition of the use of the exemption by controlled foreign corporations. To some extent, the provision will also be helpful in assuring that the exemption is not utilized in cases where the interest is effectively connected with the conduct of a trade or business in the United States and in assuring that the recipient of the interest is not a nominee for a U.S. person.

Although this provision may be a useful tool for the Internal Revenue Service, it will have limited usefulness. As a practical matter the Internal Revenue Service is unlikely to be very successful in dealing with tax haven countries, where there may be no tax administration to deal with the corporate recipients of U.S. interest may have bearer shares.

Moreover, as discussed below under "Reporting Requirements", the provision is inconsistent with one of the principal goals of the legislation—to allow obligations of U.S. corporations to trade freely in international capital markets.

Reporting Requirements.—Unfortunately, the reporting requirements which are contemplated probably prevent the proposal from realizing its general purpose. The general purpose of the proposal seems to be to make it easy to trade obligations of U.S. corporations in international bond markets. However, the proposal clearly contemplates two very substantial restrictions on free transferability. First, the exemption only applies to persons who own less than 10 percent of the voting interest. To assure that this degree of ownership is not met, the debtor will need either specific information about the lender or a certification from the lender regarding several facts. Second, the bill contemplates that the Treasury Department will receive information from the country of the recipient regarding the beneficial ownership of the interest. The Committee Report states that:

"The committee does not intend to waive the information reporting requirements which would be applicable under present law to these exempt amounts. Your committee expects that regulations will be prescribed under these provisions so that the Secretary can report back to the committee the foreign persons (and their country of residence) who are receiving the benefits of this exemption.

* * * In cases where the payor does not know the identity of the beneficial owner of the securities with respect to which the interest or original issue discount is paid, the Secretary of the Treasury may, under present law (section 1441(c) (2)), prescribe by regulations circumstances in which the payor, or any person having custody or control of the payment, will be required to withhold amounts as tax due. The committee contemplates that the Secretary will exercise this authority with respect to payments of original issue discount and interest to the extent necessary to ensure that the collection of the tax imposed upon payments of interest and original issue discount to persons owning a 10

percent or greater interest in the payor and to controlled foreign corporations."

It seems most likely that, if the proposal were enacted as drafted, the IRS would adopt a fairly strict certification procedure.[5] Interest would be free of withholding if the recipient of a specific interest payment certified (1) that he was the owner of the debt obligation, (2) that he was not a controlled foreign corporation, (3) that he did not own 10 percent or more of the debtor, actually or constructively, (4) his country of residence, (5) his name, and (6) any tax identifying number used to identify him in the country of his residence. It seems likely that this certification procedure would represent such a deterrent to purchase of the obligations that, in most cases, domestic or foreign finance subsidiaries would continue to be utilized as under current law.

ASSOCIATION OF AMERICAN RAILROADS,
Washington, D.C., June 25, 1980.

Hon. DAN ROSTENKOWSKI,
Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives.

DEAR CONGRESSMAN ROSTENKOWSKI: The Association of American Railroads supports H.R. 7553 and commends you and the Treasury Department for recommending the repeal of the current 30 percent withholding tax on foreign portfolio investments.

The railroads which are members of the Association operate 92 percent of the line-haul mileage, employ 94 percent of the workers and provide 97 percent of the freight revenues of all railroads in the United States.

We believe whatever revenue loss might occur with the enactment of H.R. 7553 is clearly outweighed by the advantages to capital formation in the United States, our balance of payments, and our ability to strengthen the dollar.

The objection raised when Treasury first proposed this repeal in 1974 was a perceived inequity in treating foreign investors more favorably than United States citizens. This has been effectively rebutted, we feel, because of the many exceptions to the current law. Moreover, the Treasury has stated that its proposal would not permit any tax reduction not avilable now to sophisticated foreign investors by circuitous arrangements permitted under the present law.

In addition, the United States economy, especially contrasted with foreign nations, has also changed dramtically since the Congress declined to repeal the withholding. Our greater lag in investment and productivity, the escalating balance of payments problems, and spiraling interest rates makes this issue more attractive to the Congress than it appeared in 1975.

Foreign companies and governments presently raise as much as $10 billion a year in the United States bond markets, free of their own withholding taxes. It is only equitable that the United States Government and domestic corporations should have similar treatment in raising bond funds from foreigners, free of our own tax.

The overall effect of the withholding tax has been to limit a large supply of funds urgently needed in our capital markets for the financing of American industry. There is virtually no industry in greater need of capital infusion than the railroad industry.

The capital needs and problems of the industry are aptly described in a recent Senate Commerce Committee Report on the economic regulation of railroads (Senate Report No. 96-470, December 7, 1979, P. 2).

"An efficiently operating transportation system is essential to the well-being of the Nation. About 20 percent of our total annual expenditures for goods and services goes for transportation of people or freight. More than 12 percent of our total civilian employment is in transportation or related industries, amounting to more than 10 million jobs in 1977. The tremendous demands on the national transportation network to move goods are evident when total freight ton-miles number over 2 trillion annually. Of this total tonnage, railroads carry over 70 percent of coal ton-miles and 60 percent of grain ton-miles. They are also the principal mode for pulp and paper products, automotive products, foodstuffs, chemical and primary metals. Unfortunately, at a time when the need for increased transport capacity is developing at a rapid pace, the railroads are the weakest sector in our transportation system, and the ability of the railroad industry to meet its future responsibilities to society is considered by many to be in doubt.

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[5] Currently a certification procedure is in force for all income except dividends, for which an address system is used. Reg. § 1.1441-6. Because of the statements in the Committee Report and the special statutory provision dealing with exchange of information, the Subcommittee anticipates that the new certification procedures would be stricter.

"Basically, the railroads cannot function without constant large infusions of capital. The ability to get capital depends on profitability. The railroads' profitability, however, has been declining since the boom World War II period when all-time peak earnings of $993 million were reported. The decline in earnings has occurred while the cost of capital has risen from 4 percent to double-digit percentages. For a disproportionate share of class I railroads, investment money is not available at any rate because of decreases in cash earnings versus increasing capital expenditure requirements on the one hand and, on the other, the increased cost of money which reduces the purchasing power of what earnings will buy.

"After adjusting for inflation, railroad ordinary income today is one-quarter its 1947 level. Over the past decade the rate of return on the investment of Class I railroads in transportation property has averaged less than 2.8 percent. In a study by the Department of Transportation entitled 'A Prospectus for Change in the Freight Railroad Industry' cash flow from internal operations and funds that could be raised from private capital markets were concluded to be insufficient to renew the existing plant and equipment and provide the capacity for anticipated levels of traffic. Specifically, cash flow from all Class I railroads in 1977 was reported to be $1.7 billion less than capital expenditures with projection that, excluding the capital requirements of ConRail, the rail industry will suffer a financial shortfall of $13 to $16 billion over the decade 1976 to 1985.

"The rail industry's historical response to inadequate financial performance has been to defer maintenance and delay capital expenditures for roadway and equipment. This practice has led to reduced speeds under slow orders on 47,200 miles of track. This, in turn, has resulted in a deterioration of the quality of rail service and loss of business. In short, many of the railroads are caught in a vicious cycle. Depressed earnings have robbed them of the ability to make improvements in plant which are needed to reduce cost and improve service. The inability to reduce costs and improve service eventually erodes the railroads' competitive position and adversely affects their net income—as the cycle is repeated."

The proposal to repeal the disincentive for foreign investment is a measure which will help the railroads attract more investors to fill their documented needs for substantially larger borrowings. We strongly recommend that the Committee approve the measure as it has done in the past and we appreciate the opportunity to submit this statement for the Record.

Sincerely,

William H. Dempsey,
President and Chief Executive Officer.

Statement of Charles W. Wheeler, Senior Tax Attorney, Tax Policy Center, Chamber of Commerce of the United States

The Chamber of Commerce of the United States is the world's largest business federation. On behalf of its more than 98,600 business and trade association members, we welcome this opportunity to support removing the withholding tax on interest paid to foreign portfolio investors.

The United States faces a critical shortage of capital. Decreasing levels of investment in American industry have contributed substantially to the decline in our productivity. The elimination of the 30 percent tax on interest paid to foreign portfolio investors could help to ease this situation by encouraging greater foreign investment in the United States.

The resulting increased foreign investment should produce more tax revenue in the United States than is currently collected from the tax on interest paid to foreign investors. In addition, higher levels of foreign investment should improve our balance of payments. The increased flow of capital from abroad will reduce the amount of dollars held overseas and help stabilize the dollar's value against other currencies.

PRESENT LAW

The taxes imposed on interest paid to foreign investors vary with the nature of the interest and the circumstances of the foreign recipient. If interest is paid to a foreign investor as a result of ongoing business activities in the United States, it is included with the other income and expenses of the business and taxed at the standard corporate or individual rates.

Interest received by a foreign investor from passive investment in the U.S. generally is subject to tax at a flat rate of 30 percent (or less under some treaties) on the gross amount paid. The tax is collected by the person paying the interest, through withholding 30 percent from the full amount to be paid. However, no tax is imposed: (1) if interest is paid to a foreign investor by a domestic corporation which earns more than 80 percent of its income from foreign sources; (2) if the interest paid to a foreign investor is in the form of original issue discount on short-term notes and bonds payable within 6 months; (3) if the interest is paid to a foreign investor who resides in any of 15 countries with which the United States has a treaty calling for the elimination of taxes on interest; or (4) if the interest is paid on deposits with a bank or savings institution.

NEED FOR ADDITIONAL CAPITAL

American business faces severe capital shortage, evidenced by declining rates of productivity as replacing worn out or obsolete capital equipment becomes more difficult.

THE 1980 ECONOMIC REPORT OF THE PRESIDENT

To reach a number of our important economic goals, the share of national output devoted to capital formation will have to increase in the 1980s. Lifting the growth of productivity from the very low levels of recent years will require an accelerated rise in the stock of capital. Environmental and related improvements will also demand large investments. Further, as discussed earlier in this chapter, we will need to invest very substantial sums in developing alternative sources of energy and improving the energy efficiency of the economy. A larger and more efficient capital stock would also help the United States to compete in world markets, improve the foreign trade balance, and strengthen the value of the dollar relative to other currencies in exchange markets. (pg. 136)

The U.S. Chamber has consistently advocated tax changes to reduce the tax bias against capital formation. We have recommended the enactment of the capital cost recovery system proposed in H.R. 4646, cuts in corporate rates, and reduction of the tax bias against individual savers and investors. The removal of the tax on interest paid to foreign portfolio investors also will reduce the difficulty of finding capital, allowing American business freer access to international markets such as the Eurodollar market.

The inherent strength and stability of this nation is one of the prime reasons that foreigners wish to invest in the United States. The growth in the economic strength of the European Community and Japan, however, has made investment in their industries increasingly attractive. Many of these countries also have helped their industries to increase their share of international investment by eliminating taxes on interest paid to international investors. This has placed American industry at a competitive disadvantage, particularly in the Eurodollar market, and attracted funds to foreign companies that might otherwise have gone to purchase American securities.

The removal of the tax on interest paid to foreign investors also will help to ease credit problems for U.S. home buyers, farmers, and small businesses. While these small borrowers generally will not be able to attract foreign investment funds, they presently compete with major corporations for the dollars available for domestic investment. By allowing U.S. businesses to sell their debt instruments in foreign markets more easily, the amount large firms need from domestic markets will be reduced. This in turn will allow more money to be made available to smaller borrowers.

INCREASED CAPITAL INVESTMENT WILL OFFSET REVENUE LOSS

The increased capital investment in the United States should produce more than enough revenue to offset the costs of eliminating this tax. The staff of the Joint Committee on Taxation estimates that the elimination of the tax will result in a revenue loss of $36 million in fiscal 1981. But if the pretax rate of return on invested capital is assumed to be 15 percent, even $1 billion of additional investment would produce $150 million in additional profits, which would result in up to $69 million in additional corporate tax revenues to the U.S. Treasury—an increase of $33 million over the revenue currently produced by the tax. In addition, the indirect benefits from increased employment could increase tax revenues even further.

TREATY NEGOTIATIONS WILL NOT SUFFER

The elimination of this tax will not affect the ability of the U.S. to negotiate tax treaties. Historically, the U.S. has had substantial investments overseas while foreign investors have had relatively small investments in the United States. In that kind of economic climate, the elimination of a tax on foreign investment in the United States was indeed an important factor in negotiating tax treaties. More recently, however, many foreign businesses have carried on extensive active operations in the United States. This has meant that both the United States and foreign governments have substantial reasons other than the tax on interest to negotiate tax treaties. The very complexity of international commerce will ensure that foreign governments have more at stake in bargaining with the U.S. than the eliminating of tax on interest paid to their citizens.

BALANCE OF PAYMENTS

The United States continues to suffer a serious balance of payments deficit. While the U.S. dollar did stabilize when compared to other currencies during 1979, its continued stabilization is far from assured. The removal of this tax should provide holders of American dollars with increased opportunities to invest those dollars in the United States. This should increase the stability of the dollar on the international currency markets until the United States can reduce its balance of payments deficit.

CONCLUSION

U.S. business currently faces a severe capital shortage and the lowest productivity levels of recent times. While the removal of the tax on interest paid to foreign portfolio investors will not totally solve this crisis, it will help ease the problem of finding additional capital to replace worn-out machines and help make American workers more productive. It is a small step toward removing the bias in our tax system against capital formation.

Statement of Jay Janis, Chairman, Federal Home Loan Bank Board, on Behalf of Federal Home Loan Bank Board and Federal Home Loan Bank System

This statement is submitted on behalf of the Federal Home Loan Bank Board and the Federal Home Loan Bank System, which, as you know, includes the Federal Home Loan Mortgage Corporation.

Both the Federal Home Loan Banks and the Federal Home Loan Mortgage Corporation issue debt instruments to fund their activities in support of the Nation's housing needs and both would benefit from a change in the current law and adoption of H.R. 7553.

The Bank Board supports H.R. 7553, a bill to remove the 30% tax on interest paid to foreign investors, for several reasons, some relating directly to the congressional mandates of the Federal Home Loan Bank Board and the Federal Home Loan Mortgage Corporation and others to our own general views toward America's place within the international capital markets. It is clear that the presence of the tax effectively eliminates any possibility of either government or private entities borrowing foreign capital without resorting to the device of using off-shore financing subsidiaries chartered solely for that purpose. Certainly any foreign lender in a country not covered by a fully reciprocal tax treaty will not be willing to accept the lowered return on investment caused by the tax. Furthermore, even if the lender's country is exempted from the tax, the paperwork, the loss of income from having to wait until year end to receive the interest and, perhaps most important, the loss of confidentiality present almost overwhelming discouragement to a potential foreign lender.

It is to the distinct advantage of the Federal Home Loan Banks and the Federal Home Loan Mortgage Corporation to be able to borow from foreign sources. As you are aware, the Bank System and the Mortgage Corporation contribute significantly to the efficiency of the thrift and housing industries in our country by providing credit to savings and loan associations and other housing finance institutions during all phases of the business cycle. In particular, the Federal Home Loan Banks act as the reserve banking system for most thrift institutions. Our continued presence and availability of funds encourages these lenders to continue making home mortgages during times when most lenders would be on the side lines. The counter-cyclical activity has contributed significantly to stabilizing the supply of new housing in our Nation. This support will be needed even more in the 1980's. Knowledgeable observers of the housing market are predicting a shortfall of funds for mortgage-related financial institutions through the traditional deposit window. Therefore, other sources of funds, such as borrowings from the capital market, will have to be sought aggressively if we are to avoid this shortfall and provide adequate funds to the mortgage market. H.R. 7553 can help.

The life blood of the Bank System and the Mortgage Corporation is our ability to raise funds from the capital markets. In 1978 and 1979 these entities, under the Bank Board's direction, obtained over $25 billion each year from the non-equity markets. Although small amounts were raised from foreign central banks and monetary authorities that are exempt from the tax, almost all of these funds were raised in the domestic market. This not only strained our financial markets but was done at relatively high rates and occassionally at unfavorable times in the market. The effectiveness of the Federal Home Loan Banks and the Mortgage Corporation rests on our ability to raise funds at the lowest possible costs and in the amounts we need. Access to foreign capital would enhance considerably our ability to achieve this goal.

The economic cycles of nations are rarely in phase with one another. As some nations enter periods or reduced growth or recession, others are experiencing renewed expansion. Likewise, the demand for financial capital within countries varies with their economic activity; as interest rates in one country soften, rates in another may rise. Because of the ever increasing degree of interdependence among nations in the world economy, investors in one country may decide the best investment at a particular time lies outside their own boundaries and conversely, borrowers might be able to borrow more cheaply abroad than at home. This flow of capital among nations is now common. During the formative stages of the U.S. economy, a substantial portion of capital used in building our railroads and factories came from Europe.

We must acknowledge that it is at times advantageous to borrow from abroad and we would recommend removing the artificial constraints preventing our government and private corporations from doing so. If the Federal Home Loan Banks and the Federal Home Loan Mortgage Corporation were able to compete for foreign capital, I am certain we would make advantageous use of the added flexibility. We must have access to the widest range of credit sources to effectively achieve our congressionally mandated goals.

Our concern for this issue extends beyond simple self interest. This tax forces American borrowers to compete in the international markets at a disadvantage. It is possible for a foreign entity to borrow U.S. dollars at will during the low points of our interest rate cycle. They can select their timing unfettred by tax considerations. However, it is difficult for American entities to take advantage of other countries' interest rate cycles because of the tax. In effect, we have made the capital flow in only one direction to the advantage of foreign borrowers. This has exacerbated our payments deficits and has contributed to the large flow of dollars abroad which now haunts us. Removal of the tax will allow us to borrow some of those dollars back and help us regain control of our currency.

The cost of removing the tax is insignificant when compared to the advantages to the Treasury and other government-sponsored agencies like ourselves.

THE FEDERAL HOME LOAN MORTGAGE CORP.,
Washington, D.C., July 1, 1980.

Hon. AL ULLMAN,
Chairman, Committee on Ways and Means,
U.S. House of Representatives.

DEAR MR. CHAIRMAN: I am writing to draw your attention to a bill now pending before the Ways and Means Committee which has important implications for housing. H.R. 7553 will enable the Federal Home Loan Mortgage Corporation, the Federal National Mortgage Association and other entities to more effectively tap the foreign capital markets, and thereby obtain funds for housing.

The bill would repeal the 30 percent withholding tax which foreign investors must pay on most debt investments in United States corporations. The 30 percent withholding tax imposed on foreign investors makes investment in such securities unattractive to foreign markets because the effective yield offered by U.S. issuers is not competitive.

As you know, FHLMC and FNMA were established by Congress to provide a secondary market for residential mortgages. Neither corporation receives Treasury funds. Both must raise funds to buy mortgages in the United States capital markets.

Studies have been conducted by Merrill Lynch and Morgan Stanley which indicate that repeal of this tax on interest generated by non-equity securities would stimulate an inflow of $5 to $7 billion annually to U.S. capital market. This inflow would improve our balance of payments, strengthen the dollar, and benefit the U.S. bond markets.

Access to foreign capital would provide the Mortgage Corporation with an additional tool to raise funds to buy mortgages when rates in the foreign markets are favorable.

During the past three years, the corporation and its dealers have been exploring the possibility of selling debt obligations to foreign investors. We have been encouraged by European investors' interest in buying our debt obligations, pending repeal of the 30 percent withholding tax. Access to foreign markets could be particularly useful during periods of rising interest rates and credit shortages in this country.

With the advent of the level playing field concept embodied in the recently passed Depository Institutions Deregulation and Monetary Control Act of 1980, the mortgage lending industry will require increasing levels of support from the secondary market corporations if mortgage housing demands are to be met. Access to foreign markets could play an important role in helping the corporations meet this challenge, especially in periods when interest rates in U.S. capital markets are escalating rapidly.

I understand that the Treasury Department strongly supports H.R. 7553 for many of the reasons I have outlined and it is confident that tax avoidance abuses by Americans will not occur with passage. The Senate Finance Committee included similar language as Section 201 of H.R. 2297, which was reported on December 15, 1979 (Senate Report No. 96–504).

In light of the potential benefits to housing and to capital formation in general, I would appreciate your support for favorable action on this legislation during the current session.

Sincerely,

PHILIP R. BRINKERHOFF,
President, Chief Executive Officer.

STATEMENT OF THE INVESTMENT COMPANY INSTITUTE

The Investment Company Institute[1] supports the proposal currently before the Subcommittee to remove the 30 percent tax on interest paid to non-resident alien portfolio investors. However, the Institute believes that if such a proposal is adopted, it should also be applied to non-resident aliens and foreign corporations who invest in interest bearing securities through mutual funds. As stated below, as of the end of 1979, the Institute had some 54 mutual fund members with assets primarily invested in bonds valued at approximately $5 billion.

BACKGROUND

Mutual funds provide an economical way by which an investor of modest means can obtain the same professional advice and diversification of investments as a wealthy individual or institution. A wealthy person can retain an investment adviser to select and manage his or her investments, and by investing in a number of different securities can achieve diversification of risk. Mutual funds are designed to permit thousands of investors to pool their resources as shareholders in a fund which in turn invests in a large number of stocks or debt instruments under the supervision of a professional investment adviser. The shareholders of the fund are the owners and are entitled to all of the fund's net income, which consists of the gross income generated by the fund's investments, less the fund's operating expenses such as investment advisory, custodial and accounting fees.

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[1] The Investment Company Institute is the national association of the American mutual fund industry. Its membership includes 519 open-end investment companies ("mutual funds"), their investment advisers and principal underwriters. Its mutual fund members have assets of about $92 billion, and have approximately 8.3 million shareholders.

There are mutual funds designed for many different investment objectives: some funds invest in common stocks; some invest in bonds issued by corporations or the federal government; and some invest in short-term money market instruments. All of the funds are regulated by the Securities and Exchange Commission under the Investment Company Act of 1940.

FEDERAL TAXATION OF MUTUAL FUNDS

Mutual funds distribute their income, including capital gains as well as ordinary income, currently to their shareholders. In order to avoid placing a federal income tax burden on persons investing through mutual funds that would be heavier than the tax burden on persons who could afford to invest directly, the Internal Revenue Code for some forty years has treated mutual funds essentially as conduits (See Int. Rev. Code §§ 851–855). Known in the Code as "regulated investment companies," mutual funds are relieved of federal income tax at the company level if they meet various specified requirements, provided they currently distribute all their income to shareholders. Each mutual fund shareholder then reflects in his or her own return the income he or she receives from the fund. The government thus obtains essentially the same revenue as if the person invested directly in a pro rata portion of the mutual fund's investment portfolio.

In order to achieve this result the Code contains certain provisions that preserve the characteristics of the fund's income when it is received by the shareholder. Thus net long-term capital gains realized by the fund, when distributed to its shareholders, are called "capital gain dividends" (See Int. Rev. Code § 852(b)(3)(C)). Dividends and interest received by the fund from domestic corporations or interest bearing securities and distributed by the fund to its shareholders are treated as dividends by the shareholders. In this manner the Code avoids levying a heavier tax on persons of modest means investing collectively via a mutual fund than on persons who can afford on their own to obtain professional investment management and to make directly a variety of diversified investments.

This conduit theory in the Code was most recently recognized in an amendment contained in the Windfall Profit Tax legislation concerning the partial exclusion of dividends and interest received by individuals. The conferees agreed that in the case of distributions received by individuals from conduct type entities such as mutual funds, the "distributions generally qualify for the exclusion to the same extent that the gross income of the entity consists of eligible dividends or eligible interests."[2]

H.R. 7553

Under present law, interest, dividends and other similar types of income of a non-resident alien or a foreign corporation are subject to a 30 percent tax on the gross amount paid. This tax is generally collected by means of withholding by the person making the payment to the foreign recipient of the income. A number of exemptions are currently provided from this 30 percent tax. In addition, various income tax treaties provide either for an exemption or a reduced rate of tax.

The Institute generally supports H.R. 7553 because the imposition of a tax on obligations issued by U.S. persons can impair the ability of U.S. corporations to raise capital in foreign markets.[3] Further, repeal of the tax should result in an infusion of foreign capital into our economy, thus reducing our balance of payments deficit, strengthening the dollar and increasing the formation of capital. Since this capital would be in the form of debt, it would not increase the exten of foreign ownership or control of United States businesses. However, H.R. 7553 should make it clear that the exemption from tax also applies to those eligible aliens who purchase the same investments through mutual funds.[4] This would be consistent with the current treatment afforded aliens who receive capital gain distributions from mutual funds. It has been a long-standing position of the Internal Revenue Service that capital gains dividends paid by mutual funds to non-resident aliens and foreign corporations are not subject to the withholding of income tax at the source, because they retain their character as long term capital gains in the hands of shareholders. Hence, those distributions are not taxable to those shareholders who are non-resident aliens and foreign corporations.[5] Therefore, interest income that would be exempt from withholding if received directly by foreign persons should like long-term capital gains, be exempt from withholding when it flows through mutual funds to eligible foreign persons.

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[2] Conf. Rept. on H.R. 3919, No. 96–817, 96th Congress, 2d session, p. 156, at 15 (Mar. 7, 1980).

[3] We note that the Senate Finance Committee has already passed a companion bi in the form of an amendment to H.R. 2297.

In its testimony before this Subcommittee on June 19, 1980, the Treasury Department foresaw two concerns to be guarded against in H.R. 7553. First, Treasury thought that this measure might create incentives for U.S. corporations to market debt obligations in bearer form in the domestic market in volumes substantially greater than today. Second, they felt that this measure might enhance the opportunities of U.S. persons to successfully evade taxes by holding interest-bearing securities "offshore". Neither of these concerns are applicable to the mutual fund industry.

Mutual fund bond funds may from time to time purchase bearer bonds for their portfolio. However, bearer bonds are purchased by mutual funds solely because they constitute a sound investment and not for tax avoidance purposes. Moreover, when the interest on such bonds is distributed to the shareholders as a dividend from the mutual fund, it is commingled with all of the other portfolio interest income. As with all mutual fund distributions, these distributions are routinely reported to the Treasury.

Persons who evade taxes by holding interest-bearing securities offshore are unlikely to purchase mutual fund shares for that purpose. Moreover, mutual fund shares have been traditionally held by persons of moderate means who cannot afford to purchase a diversified portfolio individually. Such investors are less likely to be able to afford the costs involved with holding debt securities offshore than are wealthier persons who invest directly. However, the mutual fund industry would be willing to comply with any reasonable procedures designed to insure that persons who claim the exemptions provided in H.R. 7553 are, in fact, non-resident aliens or foreign corporations.

CONCLUSION

The Investment Company Institute believes that the Congress should repeal the present 30 percent tax on interest paid to foreign investors. If such action is taken, it should be extended to foreign investors who invest in debt securities through mutual funds. Otherwise, investors investing in interest bearing obligations directly would have an advantage over those investors who obtain diversification and investment management through a mutual fund. It is essential that the principle of equality of taxation of investment income that has existed in the Code for more than forty years as between investors in mutual funds and direct investors be continued.

MORTGAGE BANKERS ASSOCIATION OF AMERICA,
Washington, D.C., July 3, 1980.

Hon. AL ULLMAN,
Chairman, Committee on Ways and Means,
U.S. House of Representatives.

DEAR MR. CHAIRMAN: On behalf of the Mortgage Bankers Association of America, the following statement is submitted for the hearing record on H.R. 7553, a bill exempting certain interest paid to non-U.S. persons from withholding taxes. The provisions of the bill that call for the repeal of the 30 percent withholding tax that foreign investors must pay on investment in U.S. corporations could have a most beneficial impact on the housing and mortgage finance industries of this country through the secondary mortgage market operations of the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC).

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[4] An informal survey conducted by the Institute indicates that as of Dec. 31, 1979, there were 54 mutual funds whose portfolio consisted primarily of bonds with total assets of $5,086,487,000. Total shareholder accounts numbered 625,197 of which less than 1 percent were non-resident alien investors. We believe that this percentage of ownership is consistent for all types of mutual funds.

[5] See Rev.Rul. 69-244, 69-1 C.B. 215 which updated and restated the position set forth in I.T. 3805. C.B. 1946-1, 120.

MBA supports the bill and strongly urges Congressional approval.

Access to foreign capital for both FNMA and FHLMC could be most advantageous to the mortgage credit situation in this country, particularly during periods of sky-rocketing interest rates and severe credit shortages, such as we have recently experienced. There has been increasing interest on the part of foreign markets in U.S. investment. However, the 30 percent withholding tax hampers the U.S. borrower abroad because of the disadvantageous effective yield. According to studies of Merrill Lynch and Morgan Stanley, the repeal of this tax could generate an inflow of $5 to $7 billion annually to the U.S. capital market. As it stands now, the foreign investor faced with buying a debt instrument subject to the withholding tax will simply turn to investments free of the tax.

The provisions of H.R. 7553 are incorporated in the Senate version of H.R. 2297, as reported out by the Senate Finance Committee on December 15, 1979 (Senate Report No. 96–504) and it is our understanding that the Treasury Department, as well as FNMA and FHLMC, strongly support this measure. We respectfully urge prompt adoption.

Sincerely,

MARK J. RIEDY,
Executive Vice President.

NEW YORK STATE BAR ASSOCIATION,
TAX SECTION,
New York, N.Y., June 19, 1980.

Hon. DAN ROSTENKOWSKI,
Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives.

DEAR CONGRESSMAN ROSTENKOWSKI: We wish to advise you of our support for the Bill you recently introduced (H.R. 7553) to exempt from tax interest received on portfolio debt investments in the United States of nonresident aliens and foreign corporations. Our position on this subject has been set forth in prior communications to the Ways and Means Committee dated March 17, 1980, and September 11, 1979, copies of which are enclosed for your convenience.

Very truly yours,

DAVID SACHS, *Chairman.*

MARCH 17, 1980.

Hon. AL ULLMAN,
Chairman, Committee on Ways and Means,
U.S. House of Representatives.

DEAR CONGRESSMAN ULLMAN: We have previously submitted to the Committee on Ways and Means and to officials of the Treasury Department a Report on the Withholding of Tax on Interest Paid by U.S. Borrowers to Foreign Lenders, issued by our Committee on U.S. Activities of Foreign Taxpayers on September 11, 1979. You acknowledged receipt of this Report by letter dated October 16, 1979 to our past chairman, Gordon D. Henderson, in which you indicated that public hearings might be held on this subject. A copy of this Report is enclosed for your convenience.

Now that the Committee on Ways and Means has scheduled such a hearing on March 25, we wish to reiterate our support for the enactment of legislation generally exempting foreign lenders from United States withholding tax on interest paid by United States borrowers. Also, we wish to make clear that we think there is a strong case for the complete (or virtually complete) elimination of withholding tax on interest and that the discussion of the more limited measures contained in our Report were based on the supposition that prior congressional opposition made it impractical to deal with a broader exclusion. (See Report, pages 19–21.) To the extent that such opposition no longer exists, we support a broader exclusion, for the reasons stated in the Report.

Sincerely,

David Sachs.

Enclosure.

Report of the Committee on U.S. Activities of Foreign Taxpayers on the Withholding of Tax on Interest Paid by U.S. Borrowers to Foreign Lenders

Except in limited situations, the 30% tax that must now generally be withheld from interest paid by U.S. corporations to nonresident aliens and nonresident foreign corporations effectively precludes the direct issuance of debt securities abroad by U.S. corporations. As a consequence, U.S. corporations issuing debt securities in foreign capital markets do so through finance subsidiary structures designed to eliminate the U.S. withholding tax. Because the Committee believes that U.S. corporations should be permitted to sell debt securities in foreign capital markets without resorting to finance subsidiaries, it supports the enactment of legislation which would exempt from U.S. withholding tax interest paid on a broad class of debt securities directly issued by U.S. corporations.[1]

The basis for the Committee's conclusion that such an exemption is appropriate is set forth in I below, and the Committee's recommendations with respect to the design of such an exemption are discussed in II below.

The Eurobond market

The principal capital market outside of the U.S. is the so-called Eurobond market. In its inception in the 1960's, the Eurobond market was largely the result of the interest equalization tax, which was imposed on purchases by U.S. persons of foreign securities and forced many foreign borrowers to raise funds outside of the U.S.; and the Foreign Direct Investment and Voluntary Foreign Credit Restraint Programs, which limited the extent to which U.S. corporations could make direct investments abroad without offsetting foreign borrowings. Since that time, however, the Eurobond market has grown enormously. With a new issue volume of $12.2 billion in the first six months of 1979,[2] the Eurobond market is a major and permanent alternate source of funds for major borrowers and the world's second largest capital market after the U.S. capital market. It is used by a broad range of borrowers, including foreign governments and government agencies, international organizations[3] and private corporations. In addition to individuals, purchasers include institutions such as banks, investment companies, insurance companies and pension funds. There is a liquid and well-capitalized secondary market with rules of fair practice enforced by the Association of International Bond Dealers.

U.S. corporations have been significant borrowers in the Eurobond market, accounting for approximately 8 percent of the 1978 new issue volume and 17 percent of the new isuse volume for the first six months of 1979. The main importance of the Eurobond market to U.S. corporations is as a source of capital which at different times may be available at lower overall cost than in the U.S. market, but it may also offer other advantages, including early redemption and other options not available for borrowings of comparable maturities in the U.S. market and debt covenants that are more flexible than those that would be required for comparable obligations in the U.S. market. Public offerings are much faster than in the U.S. market. Although a majority of issues in the Eurobond market are denominated in dollars, the Eurobond market may also be a source of foreign currency for U.S. corporations.

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[1] The Tax Section of the New York State Bar Association has previously supported such legislation. See "A Report on International Finance Subsidiaries," 28 Tax L. Rev. 439, 518–19 (1973).

[2] New issue volume rose from $164 million in 1963 to $6.3 billion in 1972. While new issues volume declined to $2.1 billion in 1974 as a result of the oil crisis and the removal of United States capital controls, it rose to $8.6 billion in 1975, to $14.3 billion in 1976 and to $17.7 billion in 1977. New issue volume for 1978 was $14.1 billion.

[3] E.g., Governmental borrowers in 1978 and 1979 included the governments of Argentina, Australia, Brazil, Canada, Costa Rica, Denmark, New Zealand, Norway, Panama, The Philippines, Spain, Sweden and Venezuela; several Canadian provinces (e.g., Quebec and Manitoba); the European Investment Bank; the European Coal and Steel Community; and different agencies of the French Government (e.g., the telephone system). International organizations borrowing in the Eurobond market included the World Bank and the African Development Bank.

Debt securities sold in the Eurobond market are free of taxes withheld at source; and the form of bond, debenture or note sold in the Eurobond market puts the risk of such a tax on the issuer by requiring the issuer to pay interest, premium and principal net of any tax that must be withheld at source, generally subject only to a right of early call in the event that such a tax is required to be withheld as a result of a change in law or its interpretation occurring after the obligations are issued. To avoid the 30 percent U.S. withholding tax, U.S. corporations have borrowed through finance subsidiaries, principally incorporated in the Netherlands Antilles. Other borrowers in the Eurobond market likewise offer debt securities that are not subject to withholding tax. This may be because foreign law specifically exempts interest from such obligations from withholding (as, for example, in the case of Australia,[4] Canada,[5] France,[6] the Netherlands,[7] Norway,[7] Sweden,[7] and Japan[8]); or by administrative interpretation (as for example, in the U.K.[9]); or by allowing the use of finance companies (as, for example, Germany). Interest paid by governmental borrowers may be exempt under special provisions.[10]

The need for a withholding tax exemption

The 30-percent U.S. withholding tax in effect denies U.S. corporations direct access to the Eurobond market, and it is axiomatic in the Committee's view that U.S. corporations will be able to continue to borrow in the Eurobond market only through finance companies so long as the Internal Revenue Code does not provide an exemption to the 30-percent withholding tax. It is not feasible for a borrower to bear the economic cost of the 30-percent U.S. withholding tax, nor is it possible to sell obligations in the Eurobond market on a basis that places the economic burden of the tax on the purchaser.

The impracticality of a U.S. borrower bearing the cost of the 30-percent withholding tax is evident. To pay $1 net of a 30-percent withholding tax requires a payment of approximately $1.43;[11] or, put differently, requires an increase of approximately 43 percent in the rate of interest. On that basis U S. borrowers will raise capital elsewhere.

For the same reason a U.S. borrower could withhold 30 percent from its interest payments, without an offsetting increase in the rate of interest, only if purchsaers were indifferent to the withholding tax. There are several reasons why purchasers are not indifferent.

First, the Eurobond market, like the United States capital market, includes pension funds and other significant investors which are tax-exempt, and for such investors any withholding tax represents an unrecoverable cost. Such investors will not choose obligations that are subject to withholding taxes so long as other credit-worthy borrowers offer obligations that are free of withholding taxes, and as set out above all obligations that are sold in the Eurobond market are free of taxes withheld at the source.

Under the Internal Revenue Code[12] no withholding is required on interest paid to a foreign government, including certain government-controlled entities, but this exemption obviously does not cover all institutional purchasers who may be tax-exempt; and it is not satisfactory even with respect to foreign governments and government-controlled entities since it is available only if the holder of the debt obligation can show to the borrower's satisfaction that the holder is covered by the exemption, an issue that may be unclear[13] or in any event may require a level of paper work that is unacceptable to purchasers.[14]

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[4] Under Section 128G of the Australian Income Tax Assessment Act interest on foreign currency bearer obligations of an Australian corporation is exempt from Australian withholding tax, subject to a certification procedure.

[5] Section 212(1)(b)(vii) of the Canadian Income Tax Act exempts from Canada's 25 percent withholding tax interest payable in a currency other than Canadian currency to a nonresident person with whom the payer is dealing at arm's length on an obligation which meets certain other conditions.

[6] Art. 62–IV of French Law No. 75–1278 of Dec. 30, 1975 exempts interest on obligations with a term of at least five years, that meet certain other conditions and are approved by the Ministry of Finance.

[7] In general, there is no withholding tax in these countries on interest received by nonresident individuals or foreign corporations that is not derived through a permanent establishment.

[8] The Special Taxation Measures Law (Law No. 26, 1965) exempts from Japan's 20 percent withholding tax interest paid on debt securities which mature more than five years from the date of issue, which are denominated in a foreign currency and which are made payable to non-resident individuals or foreign corporations not doing business in Japan through a permanent establishment.

[9] Interest paid by a U.K. company is not subject to U.K. withholding tax if it is "foreign source," which it will be if paid outside the United Kingdom on an obligation that is not governed by U.K. law, is delivered under seal and is payable as to principal and interest in a currency other than sterling. Because of restrictions on the deductibility of interest, however, U.K. companies also sometimes borrow through foreign finance subsidiaries.

[10] As, e.g., in Canada, which exempts interest on obligations of, or guaranteed by, Canada or a province or municipality of Canada.

[11] I.e., $1.43 — (30 percent × $1.43) = $1.00.

[12] Int. Rev. Code § 892.

Second, foreign tax credits, if available to investors which are taxable, cannot be expected to eliminate the cost of withholding taxes on interest. Even if a full foreign tax credit is allowed, use of the amount withheld is lost to the lender for the period between the interest payment date and the time the credit reduces the lender's tax bill and this will be viewed by lenders as effectively reducing the rate of interest. Moreover, home country taxes paid by investors are on net interest income (i.e., interest income after the deduction of related interest and other expenses), and these will usually be at an effective rate considerably lower than a withholding tax imposed on gross interest income. Where the foreign tax credit is (as in the case of the U.S. foreign tax credit) allowed for a foreign tax only to the extent that it does not exceed an allocable portion of the home country tax, a withholding tax will often simply generate an excess foreign tax credit.[15] As a consequence taxes withheld at source may not be fully creditable against home country tax liabilities. So long as other credit-worthy issuers are offering obligations on which there is no withholding tax at source, purchasers cannot be expected to run any risk that a withholding tax will not be fully available as a foreign tax credit.

No doubt the Eurobond market includes purchasers who simply do not pay income taxes to any jurisdiction and whose securities' purchases violate home country legislation, but it would be wrong to infer that the absence of withholding tax in the Eurobond market is simply an accommodation to such purchasers or that the existence of the Eurobond market is contrary to the policies of foreign governments. As previously indicated,[16] European and other foreign governments are major users of the Eurobond market. And freedom from taxes withheld at source is a feature of any international capital market, including the U.S. capital market. Obligations publicly offered by foreign governments and foreign corporations in the U.S. since the expiration of the interest equalization tax have invariably been free of foreign withholding taxes. Moreover, private placement and bank loan agreements between foreign borrowers and U.S. banks and institutional lenders customarily shift to the foreign borrower (by a "gross-up" requirement) the risk that a new foreign withholding tax might be enacted, that an existing foreign withholding tax might be increased or that the U.S. lender might not be able to credit against his U.S. tax liability the full foreign tax that must be withheld.

The 30 percent U.S. withholding tax

Subject to limited exceptions, present U.S. law requires income tax to be withheld at the rate of 30 percent on interest paid by U.S. corporations to non-resident aliens and foreign corporations not doing business in the U.S.[17] Except for interest on bank deposits and discount on commercial paper and other short-term obligations,[18] there are no significant statutory exceptions to the 30 percent withholding tax and none that would permit U.S. corporations to borrow in the Eurobond market.

A number of U.S. tax treaties eliminate the tax on interest paid to residents of the other country, but treaty exemptions are largely significant only for bank loans and private placements in national capital markets and do not provide a basis for more broadly distributed issues. There are a number of reasons why this is so. First, U.S. tax treaties are basically limited to European and other developed countries[19] and do not extend to residents of many capital rich but less developed nations; as a consequence, withholding tax exemptions in tax treaties cover only a fraction of the investors in the Eurobond market.[20] Second, U.S. tax treaties with some countries (such as Australia and Italy) do not affect the 30 percent withholding tax on interest; and U.S. treaties with a number of other foreign countries provide only for a reduction in the rate of withholding.

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[13] The question is whether the exemption will apply to separately organized government agencies, state-owned enterprises and similar institutions. Until recently there were few rulings on this question and no meaningful Regulation. While Regulations proposed on Aug. 15, 1978 clarify the Treasury's view of the exception, they leave a number of questions unanswered.

[14] E.g., the withholding tax agent may insist, even in a relatively clear case, that the purchaser obtain an Internal Revenue Service ruling.

[15] Assume a home country tax rate of 50 percent and a limitation on foreign tax credits that is similar to Section 904 of the Internal Revenue Code. For a 30 percent withholding tax to be a full foreign tax credit, the lender would have to earn a profit of at least 30/50 of the gross interest received or, put differently, if it lent at 10 percent, it would (assuming no other costs or expenses) have to borrow at 4 percent or less in order to get a full credit for the withholding tax. Such a spread is obviously unrealistic.

[16] See the footnote on page 3.

[17] The 30 percent tax is imposed by Int. Rev. Code §§ 871(a), 881(a); withholding is required by Int. Rev. Code §§ 1441, 1442.

[18] The effect of Int. Rev. Code §§ 871(a)(1)(A) and (C)(ii) and Int. Rev. Code §§ 881 (a)(1) and (3) is to exempt original issue discount on obligations payable six months or less from the date of original issue.

This is the case, for example, in the U.S. treaties with Belgium (generally, 15 percent), Canada (15 percent), France (10 percent), Japan (generally, 10 percent) and Switzerland (5 percent).

Finance subsidiaries

Because of the absence of broad exceptions to the 30 percent withholding tax, U.S. corporations have borrowed in the Eurobond market through finance subsidiaries. Such a finance subsidiary borrows in the Eurobond market and relends the proceeds to affiliates. Its obligations are guaranteed as to principal, premium and interest by the subsidiary's U.S. parent.

When the interest equalization tax legislation expired on June 30, 1974 the Internal Revenue Service ceased issuing private rulings that interest paid on obligations of finance subsidiaries was not subject to withholding, and since then issues by finance subsidiaries have been made on the basis of opinions of counsel to that effect. Such rulings were issued by the Internal Revenue Service for many years, however, and unquestionably the use of finance subsidiaries would not have developed at all if the Internal Revenue Service had not been prepared to issue such rulings in the first place.[21]

Where the purpose of borowing is to finance foreign operations, the finance subsidiary is incorporated in the U.S. The proceeds of its borrowings are relent to foreign affiliates. Withholding is not required from its interest payments because of an exemption that applies where more than 80 percent of the gross income of a U.S. corporation is foreign source income.[22] The subsidiary derives its income from interest and dividends from foreign affiliates. The requirement that the finance subsidiary must derive more than 80 percent of its gross income from foreign sources effectively precludes the use of such a subsidiary to finance U.S. operations.

Where the purpose of the borrowing is in whole or in part to finance U.S. operations, the finance subsidiary has been organized abroad, almost invariably in the Netherlands Antilles.[23] The proceeds of its borrowings are relent to U.S. affiliates. Under Article XII of the U.S.-Netherlands income tax treaty, as extended by protocol to the Netherlands Antilles, no U.S. withholding tax is imposed on interest paid by such a Netherlands Antilles corporation to a non-resident alien or foreign corporation; Article VIII of the treaty eliminates U.S. withholding on the interest that the subsidiary receives from loans to its U.S. affiliates if the Netherlands Antilles subsidiary pays Netherlands Antilles income tax at regular rates on its U.S. source income.

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[19] E.g., the United States has no tax treaty with any Middle Eastern or South American country. Treaties have been signed but not ratified with Egypt, Israel and Morocco.

[20] Moreover, reliance on tax treaties to eliminate withholding taxes, when such treaty exemptions are available, would introduce substantial complications into the secondary market. Obligations issued in the Europond market are invariably in bearer form with interest coupons attached. To effect a treaty exemption from U.S. withholding tax on a coupon bond, a signed copy of Form 1001 (Ownership, Exemption, or Reduced Rate Certificate) must be presented by the holder with each coupon.

[21] Prior to the expiration of the interest equalization tax legislation on June 30, 1974, the Internal Revenue Service issued private rulings that withholding of U.S. tax was not required if the finance subsidiary's debt to equity ratio did not exceed five to one and if certain other conditions were met. Finance companies were also sanctioned by a number of published rulings. Rev. Rul. 73–110, 1973–1 C.B. 454; Rev. Rul. 72–416, 1972–2 C.B. 591; Rev. Rul. 70–645; 1970–2 C.B. 273; Rev. Rul. 69–501, 1969–2 C.B. 233; Rev. Rul. 69–377, 1969–2 C.B. 231. Following the expiration of the interest equalization tax legislation, the Internal Revenue Service published Rev. Rul. 74–464, 1974–2 C.B. 46, which concluded that "the mere existence of a five to one debt to equity ratio . . . should no longer be relied upon" as a basis for concluding that obligations issued by finance subsidiaries, domestic or foreign, represented true indebtedness of the subsidiary. Rev. Rul. 74–464 also revoked the published rulings which had concluded that a finance subsidiary's obligations were its own indebtedness where there was such a five to one debt to equity ratio, and in a related ruling, Rev. Rul. 74–620, 1974–2 C.B. 380, the Internal Revenue Service revoked a published ruling (Rev. Rul. 72–337, 1972–2 C.B. 589) relating to preferred stock of a domestic finance subsidiary.

[22] Int. Rev. Code § 816(a)(1)(B).

[23] Limited use has also been made of the British Virgin Islands.

Objections to finance subsidiaries

The basic effect of the 30 percent U.S. withholding tax on interest is to prevent foreign borrowings in cases where the tax cannot be avoided. Its elimination would result in no loss of tax revenues to the U.S. and indeed (as explained hereafter) would probably increase U.S. tax revenues by eliminating the foreign tax credit taken for income taxes paid to the Netherlands Antilles. Elimination of withholding tax on securities issues would also be consistent with the U.S. tax treatment of bank borrowings. The U.S. exempts interest paid on bank deposits of nonresident aliens and nonresident foreign corporations from withholding tax.[34] In addition, tax treaties with major foreign bank centers, such as the U.K. and Luxembourg, eliminate U.S. withholding tax on interest so that U.S. corporations have been able to borrow from foreign banks. The effect of the exemption for interest on bank deposits and of the treaty exemptions is to permit U.S. corporations to obtain foreign capital from a bank, either U.S. or foreign.

Since no tax policy apparent to the Committee would be served by preventing U.S. corporations from borrowing in the Eurobond market,[35] it is the Committee's view that U.S. corporations should be allowed to borrow in foreign capital markets without resorting to finance subsidiaries. There are a number of reasons why we have reached this conclusion.

First, it makes no sense to force U.S. corporations to organise subsidiaries in order to borrow in foreign capital markets. No policy is served by requiring U.S. corporations to use relatively complicated[36] and formal structures in order to accomplish indirectly a purpose that, in the Committee's view, should be allowed directly.

Second, the use of Netherlands Antilles subsidiaries involves unnecessary costs. The net income of such a finance company is subject to Netherlands Antilles income tax and that tax is, in effect, passed on to the U.S. government through the foreign tax credit.[37] The amount involved here may be substantial, almost certainly amounting to more than $15 million a year.[38] Professional fees and other costs are also involved in the organisation and maintenance of such subsidiaries.

Third, the existence of Netherlands Antilles finance companies will make it difficult to achieve the U.S.'s stated objective of renegotiating the treaty arrangement between the U.S. and the Netherlands Antilles to reflect U.S. treaty policy.[39] The viability of Netherlands Antilles finance companies depends in large degree upon the continuation of Article VIII of the U.S.-Netherlands Income Tax Treaty, as extended to the Netherland Antilles by Article I of the protocol, which under specified circumstances eliminates U.S. withholding taxes on interest paid to a Netherlands Antilles company; and upon continuation of Article XII of such treaty which eliminates U.S. withholding tax on interest paid by a Netherlands Antilles company to non-resident aliens and foreign corporations, regardless of the extent to which the Netherlands Antilles company derives income from sources within the United States.[30]

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[34] Int. Rev. Code § 861(a)(1)(A) exempts interest paid on deposits with persons carrying on the banking business, including deposits or withdrawable accounts with savings and loan associations. This exemption has been applied not only to conventional deposits, but also to negotiable medium-term certificates of deposit (as, e.g., in Rev. Rul. 75-459, 1975-2 C.B. 285); and under proposed amendments to the Federal Home Loan Bank Board Regulations could apparently be used by savings and loan associations to issue mortgage-backed certificates of deposit with maturities of between five and ten years.

[35] There is no evidence that the limited elimination of the U.S. withholding tax proposed in this report would make it difficult for the U.S. in treaty negotiations to persuade other countries to agree to eliminate withholding on interest. Foreign countries that have withholding tax exemptions (e.g., the U.K., the Netherlands and Norway) have experienced no apparent difficulty in persuading other countries, including the U.S., to eliminate by treaty their withholding taxes on interest.

[36] The substantial complexities involved when finance subsidiaries issue convertible obligations are described in the NYSBA report cited on page 1.

[37] The U.S. parent of the Netherlands Antilles subsidiary will be taxed currently on the net income of the subsidiary under Subpart F and as a consequence will be deemed for foreign tax credit purposes to have paid the Netherlands Antilles income tax.

[38] The Netherlands Antilles tax authorities require that such a subsidiary report taxable income equal to at least 1 percent of the first $80 million principal amount of obligations and tax such income at an approximate rate of 30 percent. There are now outstanding approximately $5 billion of obligations of Netherlands Antilles subsidaries, so that a rough estimate of the annual tax on the relending of the proceeds of such borrowings to the U.S. would be $15 million. In addition, significant Netherlands Antilles taxes are paid in respect of income earned by the subsidiary on its equity.

[39] See Treasury Department News Release of June 27, 1979, stating the Treasury Department's intention of discussing treaty revisions with the Netherlands Antilles.

U.S. treaty policy should take into account the issue of whether the U.S. should have any treaty at all with the Netherlands Antilles, or at least whether such a treaty should confer benefits on investment that does not originate in the Netherland Antilles. Moreover, Article XII of the existing U.S.-Netherlands treaty, which overrides the Internal Revenue Code,[31] is inconsistent with current U.S. treaty policy.[32] Any renegotiation which materially affected either Article VIII or Article XII of the existing U.S.-Netherlands treaty, however, would exclude U.S. corporations from the Eurobond market. It would also upset existing financing structures (including those established prior to the expiration of the interest equalization tax legislation on June 30, 1974) unless the renegotiated treaty included effective date provisions that saved arrangements in effect prior to renegotiation or unless, as the Committee proposes, U.S. corporations are given the opportunity to assume without tax consequences the obligations of existing Netherlands Antilles finance subsidiaries.

II

In the Committee's view there is a strong case for the complete elimination of the U.S. withholding tax on interest.[33] In view of Congress' rejection of such a measure in 1976,[34] however, the Committee would support a narrower exemption if such an exemption is proposed. The exemption approved by Congress in 1971 and in effect from April 1971 until the expiration of the interest equalization tax legislation on June 30, 1974 is a useful precedent for the design of such a narrower exemption. Under Section 4912(c) of the Internal Revenue Code, U.S. corporations were entitled to elect to treat U.S. purchasers of certain debt issues as subject to interest equalization tax, in which event interest paid on such obligations was treated as foreign source and was exempt from U.S. withholding tax.[35]

With respect to the design of the exemption the Committee suggests the following:

1. The exemption would apply to debt obligations that are issued by a corporation[36] after a stated effective date and that meet the requirements set forth in 4 below. It would treat interest (and original issue discount) derived on such obligations by a non-resident alien or foreign corporation as income from sources without the United States if such income was not effectively connected with a U.S. trade or business of the recipient, with the result that such income would not be subject to U.S. withholding tax.[37] (This is the treatment afforded interest paid to nonresidtnt aliens and foreign corporations on deposits with U.S. commercial banks.)

2. The exemption would not require foreign use of the proceeds of the debt obligations. Most of the recent offerings in the Eurobond market have been by

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[30] The British Virgin Islands has also been used occasionally as a jurisdiction for finance companies. Its use depends on continuation of Article XV of the existing U.S.–U.K. income tax treaty, as extended to the British Virgin Islands, which is substantially the same as Article XII of the U.S.-Netherlands treaty, as extended to the Netherlands Antilles.

[31] Int. Rev. Code § 7852(d). Under Int. Rev. Code § 861(a)(1)(D), a proportionate part of the interest paid by a foreign corporation (other than certain interest of commercial banks) is treated as U.S. source income, and is therefore subject to U.S. withholding tax, if 50 percent or more of the corporation's income was effectively connected with a U.S. business.

[32] See, e.g., Article 11(6) of the Treasury's Model Income Tax Treaty of May 17, 1977 which permits the U.S. to tax interest paid by a corporation of the other country under certain circumstances.

[33] In addition to the reasons previously given, elimination of the withholding tax on interest would eliminate the need to deal with the difficult problem of withholding on original issue discount on obligations with a maturity of more than six months.

[34] In connection with the Tax Reform Act of 1976 the House Ways and Means Committee reported a bill that included an elimination of withholding tax on both interest and dividends except where paid to controlled foreign corporations or where paid to 10 percent or greater shareholders by a U.S. person owned to the extent of more than 50 percent by non-U.S. persons. This was rejected by the House of Representatives. The Senate Finance Committee then reported a bill that included an exemption limited to interest, but this narrower exception was rejected by the Senate.

[35] The withholding tax exemption is now set forth in Int. Rev. Code § 861(a)(1)(G).

[36] While the exemption described in this report is limited to obligations of U.S. corporations, the Committee sees no reason why it could not be extended to obligations of other borrowers, including the U.S. government, its agencies and State and local governments.

[37] An alternative means of drafting would be to exempt such interest from U.S. tax or to provide that it is not includible in gross income.

Netherlands Antilles finance subsidiaries, reflecting the fact that the proceeds are being relent to the U.S. An exemption limited to obligations used to finance foreign operations would plainly not be responsive to the capital needs of corporations that have borrowed through Netherlands Antilles subsidiaries. It would not eliminate the use of the Netherlands Antilles, which is one reason for a withholding tax exemption, and it would in effect exclude borrowings by public utilities, nondeposit borrowings by savings and loans associations and borrowings by other businesses that have no foreign operations.

3. In addition to obligations issued after a stated effective date, the exemption would apply to income from obligations outstanding on the date that were assumed thereafter by a U.S. corporation. Such an assumption provision is important in order to permit U.S. corporations to assume existing obligations of foreign and domestic finance subsidiaries. The assumption provision should make clear that the assuming U.S. corporation steps into the shoes of the finance subsidiary for U.S. tax purposes (e.g., the treatment of unamortized issue expenses, original issue discount or issue premium) and that the finance subsidiary has no income or loss on the assumption even though its obligations are trading at more or less than issue price.

4. Since the purpose of the exemption is to enable U.S. corporations to borrow in foreign capital markets, the source rule of 1 above would be limited:

(a) to income from debt obligations that are sold under circumstances that make it reasonable to conclude that the issue was designed primarily to be purchased by non-U.S. persons; and

(b) to income from debt obligations not held by significant shareholders of the issuer.

The requirement of sale to non-U.S. persons would be satisfied in the case of a publicly-distributed issue by compliance with procedures developed in connection with "no-action" letters issued under the Securities Act of 1933. These include contractual restrictions prohibiting underwriters and dealers from offering such securities to U.S. persons and delivery of definitive obligations only after 90 days from the underwriters' determination that distribution is complete and only to persons certifying that they are not U.S. persons. No other restrictions would be necessary for such issues.

5. The exemption would not be restricted to underwritten issues and in this respect would differ from the direct issuance exemption that resulted from a Section 4912(c) election. That exemption applied to interest on an obligation that was part of an issue which "when issued was purchased by one or more underwriters for the purpose of distribution through resale." The effect of this language was to exclude private placements which were not on an underwritten basis and best effort underwritings.

6. An obligation covered by the exemption should be excluded for Federal tax purposes from the gross estate on a non-resident alien decedent. The initial failure to provide such an estate tax exclusion for obligations covered by the direct issuance exemption that resulted from a Section 4912(c) election limited the use of the exemption until this oversight was corrected in 1973.

7. The direct issuance exemption that resulted from a Section 4912(c) election applied only to obligations with an original maturity of fifteen years or less. While the Committee sees no reason for such a restriction, it has no objection to such a provision. We suggest, however, that the permitted original maturity be 20 years or less in order to reflect practices now current in the Eurobond market.

In connection with the Tax Reform Act of 1976 Congress considered and rejected a provision that would have eliminated the U.S. withholding tax on interest and dividends. The proposal made above is different from that rejected in 1976, which would have exempted interest paid on all obligations of U.S. residents (exempt where paid to controlled foreign corporations or to certain related persons) regardless of when the obligation was issued or whether it was designed to be sold in foreign capital markets. But wholly apart from the differences between the proposal made in this report and that previously considered, it is the Committee's view that the increased importance to U.S. corporations of foreign capital during the last several years justifies Congressional reconsideration of the 30 percent withholding tax on interest.

H.R. 1806

[H.R. [illegible], 96th Congress, 2d session]

A BILL To amend the Internal Revenue Code of 1954 to amend the provisions relating to employee stock ownership plans and for other purposes

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

(a) Short Title.—This Act may be cited as the "Employee Stock Ownership Improvements Act of 1980".

SEC. 2. CASH DISTRIBUTION OPTION AND PUT OPTION FOR STOCK BONUS PLANS.

(a) In General.—Subsection (a) of section 401 of the Internal Revenue Code of 1954 (relating to requirements for qualification) is amended by inserting immediately before the last sentence thereof the following new paragraph:

> "(23) A stock bonus plan which otherwise meets the requirements of this section shall not be considered to fail to meet the requirements of this section because it provides a cash distribution option to participants if that option meets the requirements of section 409A(h)(2).".

(b) Effective Date.—The amendment made by subsection (a) shall apply with respect to plan years beginning after December 31, 1979.

SEC. 3. LIMITATION ON ANNUAL ADDITIONS TO PARTICIPANT ACCOUNTS UNDER EMPLOYEE STOCK OWNERSHIP PLANS.

(a) In General.—Subparagraph (A) of section 415(c)(6) of the Internal Revenue Code of 1954 (relating to special limitation for employee stock ownership plan) is amended by inserting ", or purchased with cash contributed," after "contributed".

(b) Effective Date.—The amendment made by subsection (a) shall apply with respect to years beginning after December 31, 1979.

SEC. 4. VALUATION OF EMPLOYER SECURITIES IN TAX CREDIT EMPLOYEE STOCK OWNERSHIP PLANS.

(a) In General.—Clause (i) of section 48(n)(6)(B) of the Internal Revenue Code of 1954 (relating to definition of value for employer securities) is amended by striking out "the due date for filing the return for the taxable year (determined with regard to extensions)" and inserting in lieu thereof "the date on which the securities are contributed to the plan".

(b) Effective Date.—The amendments made by subsection (a) shall apply with respect to taxable years beginning after December 31, 1979.

SEC. 5. PARTICIPATION OF SUBSIDIARY CORPORATION IN TAX CREDIT EMPLOYEE STOCK OWNERSHIP PLAN.

(a) In General.—Paragraph (4) of section 409(A)(l) of the Internal Revenue Code of 1954 (relating to definition of controlled group of corporations) is amended—

(1) by striking out the caption and inserting in lieu thereof "(4) Application to controlled group of corporations.—",

(2) by striking out "Common parent may own only" in the caption of subparagraph (B) and inserting in lieu thereof "Where common parent owns at least", and

(3) by adding at the end thereof the following new subparagraph:

"(C) Where common parent owns 100 percent of first tier subsidiary.—For purposes of subparagraph (A), if the common parent owns directly stock possessing all of the voting power of all classes of stock, and all of the nonvoting stock, in a first tier subsidiary, and if the first tier subsidiary owns directly stock possessing at least 50 percent of the voting power of all classes of stock, and at least 50 percent of each class of nonvoting stock, in a second tier subsidiary of the common parent, such second tier subsidiary (and all other corporations below it in the chain which would meet the 80 percent test of section 1563(a) if the second tier subsidiary were the common parent) shall be treated as includable corporations.".

(b) Effective Date.—The amendments made by subsection (a) shall apply with respect to qualified investment for taxable years beginning after December 31, 1978.

SEC. 6. PARTICIPATION RULES FOR TAX CREDIT EMPLOYEE STOCK OWNERSHIP PLAN WHICH IS ONLY EMPLOYER-PROVIDED ALTERNATIVE TO INDIVIDUAL RETIREMENT SAVINGS.

(a) In General.—Subsection (b) of section 410 of the Internal Revenue Code of 1954 (relating to eligibility) is amended—

(1) by redesignating paragraph (2) as (3),

(2) by striking out "paragraph (1)" in paragraph (3) (as so redesignated) and inserting in lieu thereof "paragraphs (1) and (2)", and

(3) by inserting after paragraph (1) the following new paragraph:

"(2) Special rule for certain plans.—A trust which is part of a tax credit employee stock ownership plan which is the only plan of an employer intended to qualify under section 401(a) shall not be treated as not a qualified trust under section 401(a) solely because it fails to meet the requirements of paragraph (1) if—

"(A) it benefits 50 percent or more of all the employees who are eligible under the plan (excluding employees who have not satisfied the minimum age and service requirements, if any, prescribed by the plan as a condition of participation), and

"(B) the sum of the amounts allocated to each participant's account for the year does not exceed 2 percent of the compensation of that participant for the year.".

(b) Effective Date.—The amendments made by subsection (a) shall apply with respect to plan years beginning after December 31, 1979.

SEC. 7. ROLLOVER TREATMENT FOR CERTAIN DISTRIBUTIONS FROM MONEY PURCHASE PENSION PLANS.

(a) General Rule.—Paragraph (6) of section 402(a) of the Internal Revenue Code of 1954 (relating to special rollover rules) is amended by adding at the end thereof the following new subparagraph:

"(E) Special rule where employer maintains money purchase plan and other pension plan.—

"(i) In general.—In the case of any distribution from a money purchase pension plan which is maintained by an employer, subsection (e)(4)(C) shall be applied, for purposes of paragraph (5)(D)(i)(II), by not taking into account any pension plan maintained by such employer which is not a money purchase plan. The preceding sentence shall not apply to any distribution which is a qualifying rollover distribution without regard to this subparagraph.

"(ii) Treatment of subsequent distributions.—If—

"(I) any distribution of the balance to the credit of an employee from a money purchase pension plan maintained by an employer is treated as a qualifying rollover distribution by reason of clause (i) and

"(II) any portion of such distribution is transferred in a transfer to which paragraph (5)(A) applies,

then paragraph (2) of subsection (a), and paragraphs (1) and (2) of subsection (e), shall not apply to any distribution (after the taxable year in which the distribution described in subparagraph (A) of paragraph (5) is made) of the balance to the credit of such employee from any other pension plan maintained by such employer.".

(b) Effective Dates.—

(1) In general.—The amendment made by subsection (a) shall apply to payments made in taxable years beginning after December 31, 1978.

(2) **Transitional rule.**—In the case of any payment made before January 1, 1981, in a taxable year beginning after December 31, 1978, which is treated as a qualifying rollover distribution (as defined in section 402(a)(5)(D)(i) of the Internal Revenue Code of 1954) by reason of the amendment made by subsection (a), the applicable period specified in section 402(a)(5)(C) of such Code shall not expire before the close of December 31, 1980.

SEC. 8. REPEAL OF VOTING RIGHTS PASS-THROUGH REQUIREMENT FOR DEFINED CONTRIBUTION PLANS.

(a) **In General.**—Subsection (a) of section 401 of the Internal Revenue Code of 1954 (relating to requirements for qualification) is amended by striking out paragraph (22).

(b) **Effective Date.**—The amendment made by subsection (a) shall apply with respect to employer securities acquired after December 31, 1979.

SEC. 9. APPLICATION OF CASH OR DEFERRED ARRANGEMENT RULES TO CAFETERIA PLANS.

(a) **In General.**—Paragraph (2) of section 125(d) of the Internal Revenue Code of 1954 (relating to deferral compensation plans excluded) is amended by adding at the end thereof the following: "The preceding sentence shall not apply in the case of a profit-sharing or stock bonus plan which includes a qualified cash or deferred arrangements (as defined in section 401(k)(2)) to the extend of amounts which a covered employee may elect to have the employer pay as contributions to a trust under such plan on behalf of the employee.".

(b) **Effective Date.**—The provisions of subsection (a) shall apply with respect to taxable years beginning after December 31, 1979.

Summary[1]

1. CASH DISTRIBUTION OPTIONS AND PUT OPTIONS FOR STOCK BONUS PLANS (SEC. 2 OF THE BILL AND NEW SEC. 401(A)(22) OF THE CODE)

Present law

Under present law, tax-qualified stock bonus plans must generally distribute stock to participants entitled to a distribution. However, a stock bonus plan which is either a tax credit employee stock ownership plan or an employee stock ownership plan may distribute cash, subject to a participant's right to demand that benefits be distributed in the form of employer securities.

Issue

The issue is whether a tax-qualified stock bonus plan generally should be eligible for the same rules with respect to cash and stock distributions to participants which govern tax credit employee stock ownership plans and employee stock ownership plans.

Explanation of provision

The provision would permit a tax-qualified stock bonus plan to distribute cash to a participant entitled to a distribution, subject to the participant's right to demand that benefits be distributed in the form of employer stock. If a stock bonus plan provides for cash distributions and if stock which is distributed is not readily tradable on an established market, the participant would have to have the right to require the employer to repurchase the stock.

Effective date

The provision would be effective for plan years beginning after December 31, 1979.

Revenue effect

It is estimated that this provision will not have any revenue effect.

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[1] The provisions of this bill have been reported by the Senate Finance Committee as amendments to H.R. 2492 (secs. 301, 303–306, 405, 408 and 409; S. Rept. 96–684).

2. SPECIAL LIMITATION FOR TAX CREDIT EMPLOYEE STOCK OWNERSHIP PLANS AND EMPLOYEE STOCK OWNERSHIP PLANS (SEC. 3 OF THE BILL AND SEC. 415(C)(6)(A) OF THE CODE)

Present law

Under present law, the dollar limitation on annual additions with respect to a participant in a tax credit employee stock ownership plan or an employee stock ownership plan may be increased, provided certain requirements with respect to allocations of employer contributions are met. The amount of such increase is the lesser of (1) the usual dollar limitation on annual additions to a participant's account or (2) the amount of employer securities contributed to the plan.

Issue

The issue is whether a clarifying change to the rule of present law which allows an increase in the limitation on contributions with respect to a participant in a tax credit employee stock ownership plan or an employee stock ownership plan is needed to make it clear that cash used to purchase employer securities is included for purposes of determining the limitation on annual additions to a participant's account.

Explanation of provision

Under the provision, the increase in the dollar limitation on annual additions with respect to a participant in a tax credit employee stock ownership plan or an employee stock ownership plan (provided certain requirements are met with respect to allocations under the plan) would be the lesser of (1) the usual dollar limitation on annual additions to a participant's account, or (2) the amount of employer securities (or cash used to acquire such securities) contirbuted to the plan.

Effective date

The provision would be effective for years beginning after December 31, 1979.

Revenue effect

It is estimated that this provision will not have any revenue effect.

3. VALUATION OF EMPLOYER SECURITIES IN TAX CREDIT EMPLOYEE STOCK OWNERSHIP PLANS (SEC. 4 OF THE BILL AND SEC. 48(N)(B)(i) OF THE CODE)

Present law

Under present law, the value of employer securities listed on a national exchange which are contributed to a tax credit employee stock ownership plan is the average of closing prices for such securities for the 20 consecutive trading days immediately preceding the due date for filing the employer's tax return for the year (including extensions).

Issue

The issue is whether the average closing price of employer securities during the 20 trading days preceding the date of contribution to a plan should be used to determine the value of those securities. It is said that the provision of present law for valuing readily tradable employer securities contributed to a tax credit employee stock ownership plan causes employers to postpone contributions of employer securities to a tax credit employee stock ownership plan until the due date for filing the employer's tax return.

Explanation of provision

Under the bill, the value of employer securities listed on a national exchange contributed to a tax credit employee stock ownership plan would be the average of the closing prices of such securities for the 20 consecutive trading days immediately preceding the date of contribution to the plan.

Effective date

The provision would be effective for taxable years beginning after December 31, 1979.

Revenue effect

It is estimated that this provision will not have any revenue effect.

4. PARTICIPATION OF SUBSIDIARY CORPORATION IN A TAX CREDIT EMPLOYEE STOCK OWNERSHIP PLAN (SEC. 5 OF THE BILL AND SEC. 409A(1)(4)) OF THE CODE

Present law

The present-law rules governing tax credit employee stock ownership plans permit a 50-percent owned first-tier subsidiary of a parent corporation, and 80-percent owned second and lower-tier subsidiaries, to contribute employer securities of the parent corporation to a tax credit employee stock ownership plan.

Issue

The issue is whether in the case where a first-tier subsidiary corporation owns 50 percent of a second-tier subsidiary and the first-tier subsidiary is 100-percent owned by a parent corporation, sufficient control of the second-tier subsidiary by the parent corporation exists to permit the second-tier subsidiary to contribute employer securities of the parent to a tax credit employee stock ownership plan.

Explanation of provision

Under the provision, if a parent corporation owns 100 percent of a first-tier subsidiary and the first-tier subsidiary owns 50 percent of a second-tier subsidiary, the second-tier subsidiary is allowed to contribute employer securities of the parent corporation to its tax credit employee stock ownership plan. In addition, parent stock could be contributed by 80-percent owned lower-tier subsidiaries in this chain.

Effective date

The provision would be effective as if it had been included in section 141 of the Revenue Act of 1978.

Revenue effect

It is estimated that this provision will not have any revenue effect.

5. RETIREMENT SAVINGS BY TAX CREDIT EMPLOYEE STOCK OWNERSHIP PLAN PARTICIPANTS (SEC. 6 OF THE BILL AND SEC. 410(B)(1) OF THE CODE)

Present law

Under present law, an employee who is an active participant in a tax-qualified plan during a year is not eligible to make deductible contributions to an IRA (individual retirement account, individual retirement annuity, or retirement bond). Therefore, if an employee is an active participant in a tax-qualified tax credit employee stock ownership plan during a year such employee is ineligible for an IRA. A plan can allow an employee to elect not to participate in a tax credit employee stock ownership plan in order to allow the employee to establish an IRA. However, the plan may be unable to satisfy certain minimum requirements of the Code relating to employee eligibility for plan participation (sec. 410(b)(1)).

Issue

The issue is whether in the case where the only tax-qualified plan maintained by an employer is a tax credit employee stock ownership plan and if the value of employer securities allocated to employees' accounts under the tax credit employee stock ownership plan is relatively low, the minimum coverage requirements for tax-qualification of the tax credit employee stock ownership plan should be modified to permit employees to elect out of the plan, if the plan so provides, to establish IRAs.

Explanation of provision

Under the provision, the minimum coverage requirement for a tax credit employee stock ownership plan would be changed, if a tax credit employee stock ownership plan is the only tax-qualified plan maintained by an employer. If employees are permitted to elect out of the tax credit employee stock ownership plan for the purpose of establishing IRAs, the tax credit employee stock ownership plan would not fail to meet the minimum coverage requirements of the Code if the plan benefits at least 50 percent of all employees (excluding employees who have not satisfied the minimum age and service requirements or who are otherwise permitted to be excluded), and if the total allocations under the tax credit employee stock ownership plan are equal to no more than two percent of the compensation of participating employees.

Effective date

The provision would be effective for plan years beginning after December 31, 1979.

Revenue effect

It is estimated that this provision will decrease budget receipts by less than $5 million annually.

6. CERTAIN DISTRIBUTIONS FROM MONEY PURCHASE PENSION PLANS (SEC. 7 OF THE BILL AND SEC. 402(A)(6) OF THE CODE)

Present law

An employee who receives a lump sum distribution from a tax qualified pension, profit-sharing, or stock bonus plan may defer tax on the distribution by rolling over the proceeds (net of any employee contributions) within 60 days of receipt (1) to an IRA (an individual retirement account, annuity, or bond), (2) to another qualified pension, etc., plan. The rollover rule also applies to the spouse of an employee who receives a lump sum distribution on account of the employee's death. A lump sum distribution from a qualified plan is eligible for favorable income tax treatment (e.g., 10-year income-averaging) if no portion of the distribution is rolled over.

A distribution may be rolled over if it is a distribution of the balance to the credit of an employee under a qualified pension, etc., plan, made within one taxable year of the recipient. Generally, the distribution must have been made on account of death, separation for service, or the attainment of age 59½. If employer maintains more than one qualified plan of the same type, the plans are aggregated for the purpose of determining whether the balance to the credit of an employee has been distributed. Under the aggregation rules, all pension plans (defined benefit and money purchase) maintained by the employer are treated as a single plan, all profit-sharing plans maintained by the employer are treated as a single plan, and all stock bonus plans maintained by the employer are treated as a single plan.

Issue

The issue is whether the lump sum distribution rollover rules are too restrictive in the case where an employer maintains both a pension plan and a money purchase pension plan for its employees.

Explanation of provision

The bill would allow an employee who receives a total distribution (which otherwise meets the requirements for a tax-free rollover) from a qualified money purchase pension plan to roll over the distribution to an IRA or to another qualified plan where the employer also maintains a defined benefit pension plan covering the employee and a total distribution is not made from the defined benefit plan in the same taxable year. The provision would also apply to the spouse of an employee if the spouse receives such a total distribution on account of the employee's death.

If the recipient rolls over a total distribution from a money purchase pension plan and, in a subsequent taxable year, receives a total distribution from a qualified defined benefit pension plan maintained by the employer, the later plan distribution could be rolled over tax-free (if it otherwise qualifies for tax-free rollover treatment) but would not otherwise be eligible for the favorable income tax treatment accorded lump sum distributions.

Effective date

Generally, this provision would apply to payments made in taxable years beginning after December 31, 1978. In the case of such payments made after December 31, 1978, and before January 1, 1981, the period for making a rollover would not expire before December 31, 1980.

Revenue effect

It is estimated that this provision will decrease budget receipts by less than $5 million annually.

7. VOTING RIGHTS PASSTHROUGH REQUIREMENTS FOR DEFINED CONTRIBUTION PLANS (SEC. 8 OF THE BILL AND SEC. 410(A)(22) OF THE CODE)

Present law

Under present law, a tax-qualified defined contribution plan is required to pass through voting rights on employer securities to plan participants with respect to major corporate issues under certain circumstances. The vote pass-through applies if (1) the employer which established the plan does not have a class of publicly traded stock, (2) the plan acquired employer securities after December 31, 1979, and (3) after the acquisition more than 10 percent of the plan's total assets are invested in employer securities.

Issue

The issue is whether this requirement will inhibit the contribution of closely held employer securities to defined contribution plans, such as stock bonus plans and profit-sharing plans.

Explanation of provision

The provision would repeal the present law rule under which a tax-qualified defined contribution plan, established by an employer whose stock is not publicly traded, which acquires employer securities after December 31, 1979, and thereafter holds more than 10 percent of its assets in employer securities, is required to pass through to plan participants voting rights on major corporate issues with respect to employer securities held by the plan. The provision does not change the special vote pass-through rules for tax credit employee stock ownership plans.

Effective date

The provision would be effective for securities acquired after December 31, 1979.

Revenue effect

It is estimated that this provision will not have any revenue effect.

8. CAFETERIA PLANS PERMITTED TO PROVIDE DEFERRED COMPENSATION UNDER RULES APPLICABLE TO CASH OR DEFERRED PROFIT-SHARING AND STOCK BONUS PLANS (SEC. 9 OF THE BILL AND SECS. 125 AND 410(K) OF THE CODE)

Present law

A cafeteria plan is an employee benefit plan under which a participant may choose between taxable benefits and one or more nontaxable fringe benefits. Under present law, cafeteria plans are not permitted to provide deferred compensation.

Issue

Both cafeteria plans and cash or deferred profit-sharing plans allow employees to choose between current compensation and other benefits. The issue is whether present law is too restrictive because it does not permit employees to choose amoung currently taxable compensation, deferred compensation, and fringe benefits under a single plan.

Explanation of provision

Under the bill, benefits under a cafeteria plan could include amounts which an employee covered by a profit-sharing or stock bonus plan with a qualified cash or deferred arrangement can elect to have the employer pay as a contribution to a trust under a profit-sharing or stock bonus plan. Amounts contributed by the employer, pursuant to the employee's election, will be treated as nontaxable benefits for purposes of the "cafeteria" plan rules.

Effective date

The provision would be effective for taxable years beginning after December 31, 1979.

Revenue effect

It is estimated that this provision will decrease budget receipts by less than $5 million annually.

THE ESOP ASSOCIATION OF AMERICA,
San Francisco, Calif., July 1, 1980.

Re. Comments on H.R. 7606 and H.R. 7604.

JOHN M. MARTIN, Jr.,
Chief Counsel, Committee on Ways and Means,
U.S. House of Representatives

DEAR MR. MARTIN: This letter will present comments in favor of the above-referenced bills. These comments have been prepared on behalf of The ESOP Association of America, a non-profit association of companies which maintain some form of "employee stock ownership plan" for the benefit of their employees.

The Association was unable to present testimony at the hearing held on June 26th by the Subcommittee on Select Revenue Measures, due to the late date on which the "ESOP" bills were included on the agenda. Accordingly, we respectfully request that the following comments be included in the official records of that hearing.

H.R. 7606

As you know, H.R. 7606 reflects the ESOP-related provisions included in H.R. 2492, which has been reported out of the Senate Committee on Finance. We strongly support H.R. 7606 and urge the Committee to favorably report the bill at an early date. To a large extent, the provisions of H.R. 7606 will correct problems which were created under the Revenue Act of 1978 and which were not addressed in the Technical Corrections Act of 1979. The following are our specific comments relating to the various provisions of H.R. 7606, identified by section number:

SEC. 2.—CASH DISTRIBUTION OPTION AND PUT OPTION FOR STOCK BONUS PLANS

We strongly support the concept of extending a "cash distribution option," similar to Code Section 409A(h), to stock bonus plans which are not statutory "ESOPs" under Code Section 4975(e)(7). The present Income Tax regulations, at Section 1.401-1(a)(2)(iii) and (b)(1)(iii), specify that benefits under a stock bonus plan are "distributable" in stock of the employer. The Internal Revenue Service interprets its own regulations to require distribution in stock, even if the employee wishes to receive cash, and ignores the fact that "distributable" means "capable of being distributed." The proposed amendment to Section 401(a) would clarify this matter and provide greater case in the administration of stock bonus plans.

We are concerned, however, that the proposed amendment also extends the onerous "put option" rules of Code section 409A(h)(1)(B) to a stock bonus plan which elects to utilize a "cash distribution option." We surely do not oppose the concept of creating a "market" for stock of a closely-held corporation distributed by a stock bonus plan. We believe, however, that allowing an employee the choice of receiving "cash or stock" at the time of distribution is sufficient to enable an employee to "cash out" his interest under the plan, if he so elects.

The specific provisions of Code Section 409A(h)(1)(B) would require the employer to stand ready for an extended period of time to repurchase the distributed stock. This creates a major problem in the case of banks and similar financial institutions. Under both Federal and state banking laws, a bank is prohibited from repurchasing its own stock. Accordingly, a closely-held bank could not utilize the "cash distribution option" (if tied to a "put option" requirement) in connection with its stock bonus plan without violating the terms of its chartering statute.

We recommend that the proposed amendment to Code Section 401(a) be revised under H.R. 7606 to read as follows:

"(23) A stock bonus plan which otherwise meets the requirements of this section shall not be considered to fail to meet the requirements of this section merely because under the plan the benefits may be distributed in cash or in the form of stock of the employer, so long as each participant who is entitled to a distribution from the plan has a right to demand that his benefits be distributed in the form of employer stock."

SEC. 3.—LIMITATION ON ANNUAL ADDITIONS

This proposed amendment to Code Section 415(c)(6) would clarify that the increased "annual additions" allowed for certain ESOPs and TRASOPs will not be limited to stock contributed to the plan by the employer. The original intent of the provision (added by the Tax Reform Act of 1976) was to include not only contributed stock, but also stock purchased with employer contributions in cash or with the proceeds of an ESOP loan under Code Section 4975(d)(3). We suggest that the Committee report relating to H.R. 7606 specifically provide that "... purchased with cash contributions ..." is intended to include stock acquired through an ESOP loan which is repaid with cash contributions.

SEC. 4.—VALUATION OF EMPLOYER SECURITIES

This provision would make an important "technical" amendment which was omitted from the 1979 Technical Corrections Act. The present Code provisions require that a contribution of publicly-traded stock to a TRASOP be valued based upon market prices for twenty days preceding the due date for filing the employer's Federal tax return, even if the contribution is made at an earlier date. The effect of the present Code provision is to discourage the "advance funding" of a TRASOP, and we strongly recommend this necessary amendment to Code Section 48(n)(6)(I).

SEC. 5.—PARTICIPATION OF SUBSIDIARY CORPORATION

This proposed amendment to Code Section 409A(1)(4) would extend TRASOP coverage to certain "second tier" subsidiaries which are precluded from participation under the present rules. We strongly support any such provision which will extend TRASOP coverage to a greater number of employees.

SEC. 6.—PARTICIPATION RULES FOR TRASOP

This proposed amendment to Code Section 410(b) would prevent certain TRASOPs from being "disqualified" in the event a number of employees "opt out" in order to make contributions to an IRA. We strongly support any such provision which will allow the expansion of TRASOPs in a situation where qualified coverage of employees may otherwise be difficult to secure.

SEC. 7.—ROLLOVER TREATMENT FOR CERTAIN DISTRIBUTIONS

This proposed amendment to Code Section 402(a)(6) would permit a tax-free "rollover" of a lump sum distribution from a money purchase pension plan, even when a participant is also covered under a defined benefit plan from which a lump sum distribution is not made. We support this "technical" amendment as a means of further providing for the tax-deferred treatment of amounts accumulating for retirement income purposes. The present provisions of Code Section 402(e)(4)(C)(i) serve to defeat Congressional intent to encourage retirement security for employees.

SEC. 8.—REPEAL OF VOTING RIGHTS PASS-THROUGH

We strongly support Sec. 8 of H.R. 7606, which would repeal existing Code Section 401(a)(22). Although we believe that voting rights for employees may be desirable, we feel that any decision to "pass-through" voting rights to ESOP participants should be left to the decision of the sponsoring company.

Section 401(a)(22), as added to the Code by the 1978 Revenue Act, has served to discourage many closely-held companies from establishing ESOPs for the benefit of their employees. In addition, if Section 401(a)(22) is not deleted from the Code, many companies may terminate their ESOPs or elect to stop placing additional shares of employer stock in their ESOPs.

The present provisions of Sections 401(a)(22) and 409A(e)(3) create undue burdens for closely-held company ESOPs. In many situations, the expenses of soliciting proxies from ESOP participants are required even when the ESOP stock cannot in any way affect the results of a shareholder vote (for example, in a situation where the ESOP owns less than 25% of the outstanding shares). Further, the present provisions of Section 409A(e)(3) require that in some states a solicitation of employee proxies be made where the only action to be taken is a change in the corporate name. We believe that the expenses and detriment to closely-held corporations and to ESOP participants in requiring a pass-through of voting rights far outweigh any benefits to be gained.

It is clear to us that the provisions of Code Section 401(a)(22) resulted from major misunderstandings in connection with the development of the Revenue Act of 1978. The present provisions are unworkable and will result in a denial of "ownership-sharing" opportunities to many employees of closely-held companies which would otherwise establish or continue to fund ESOPs. Such a result is certainly inconsistent with Section 803(h) of the 1976 Tax Reform Act, which stated the intent of Congress to encourage the formation of ESOPs. We strongly recommend that the Committee favorably act upon the proposal to delete Section 401(a)(22) from the Code at the earliest possible date.

SEC. 9.—APPLICATION OF CASH OR DEFERRED ARRANGEMENT RULES TO CAFETERIA PLANS

The proposed amendment to Code Section 125(d)(2) would extend the "cafeteria plan" rules to certain qualified cash or deferred arrangements under Code Section 401(k). We support this provision as a means of correcting an oversight in the 1978 Revenue Act provisions. We believe that the protections included in Code Sections 125 and 401(k) are sufficient to prevent any abuse and that this "technical correction" should be enacted.

H.R. 7604

We understand that several witnesses at the hearing on June 26th testified in favor of H.R. 7604. That bill provides for "tax-free rollover" treatment for the proceeds of a sale of "small business stock" to an ESOP if such proceeds are reinvested in other "small business stock." We urge the Committee to decide that the June 26th hearing constituted formal consideration of H.R. 7604, in order that the Congress may enact this bill (S. 2677 in the Senate) at an early date.

H.R. 7604 would provide a needed incentive for a business owner to transfer stock to an ESOP for the benefit of employees. Under present law, there is an incentive for such an owner to sell a company through a tax-free reorganization with another corporation. The bill would allow similar tax-free exchanges of stock following the sale of stock to an ESOP, thereby transferring ownership to employees rather than to a conglomerate or other major corporation. The bill would provide further evidence of Congressional intent to encourage employee ownership in a manner which would not result in large losses of revenue. We strongly urge the Committee to act favorably upon H.R. 7604 at an early date.

We appreciate the opportunity to present these comments for inclusion in the hearing record and for consideration by the Committee. We would be pleased to expand upon these comments, if requested, and to work with the Committee and its staff in developing an ESOP bill for consideration by the House. Please contact the undersigned at (415) 788-7200 if we may be of assistance to you.

Respectfully submitted.

Ronald L. Ludwig,
Legal Counsel and
Chairman of Legal Advisory Committee.

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